INCOME TAX PROCEDURE 1923

INCLUDING
FEDERAL CAPITAL STOCK TAX,
FEDERAL ESTATE TAX, AND SUPPLEMENT
TO EXCESS PROFITS TAX PROCEDURE, 1921

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PREFACE

During the year 1922 we have heard many tax rumblings but we have had no new federal tax law. It is not reasonable to suppose that we shall have a new law, or any important amendments to the present law until after March 4, 1923, when the present Congress expires.

If there is no special session, and there is no intelligent demand for it, and since a new law cannot be passed in so short a time as the month of December, 1923 of the regular session, it probably will be some time in 1924 before any substantial changes in the tax laws need be expected. As of January 1, 1924, however, I expect to see changes in the present law. As no one can foresee what Congress will do, it is a waste of time to attempt to forecast the changes. However, I will waste just a little. I think that Congress will muddle a lot about taxing stock dividends and undistributed surplus, and another excess profits tax law—and leave most of the present procedure unchanged. I think the reorganization, exchange and capital gains provisions will, in the course of time, be made less liberal. I think other changes will be made which will ostensibly solve administrative doubts, but which will in reality increase the text of the law, which is now verbose beyond reason. We need a shorter law. It can be done, but not intelligently if its final form is left to the decision of a highly partisan and uninformed conference committee.

The report of the Tax Simplification Board, dated December 2, 1922, confirms a statement frequently made but not always believed that an excess profits tax bears more heavily on small concerns than on large ones. The report says:

> . . . . Quite aside, then, from the tendency of the excess profits tax law to put upon the smaller and more conservatively managed corporations an onerous and discriminatory

burden, the difficulties to be found in the determination of invested capital are almost insurmountable.

In view of the foregoing authoritative statement it is not probable that a similar tax law will be re-enacted. The report of the Board reviews the difficulties which the Treasury has had in determining depletion of natural resources, depreciation, amortization of war facilities, and in dealing with claims for refund, credit and abatement. The report holds out this hope:

> The Board has given particular attention to the completion of the audits of income tax returns. The importance of this work with respect to such of the audits of 1917 returns as remain unfinished is especially pressing on account of the running of the statute of limitations. In this emergency everything possible, consistent with fairness to the taxpayer, should be done to expedite the audit of these returns. They are now being given the right of way. This course, coupled with the elimination of a number of sources of delay, has resulted in a marked increase in the dispatch of business. The determination of invested capital under the excess profits tax law and the valuation of natural resources have been the chief obstacles in the way of completing the audits of 1917 returns. With these elements established for the year 1917, the work of auditing the returns of subsequent years will be greatly facilitated. Generally speaking, the audit of a 1917 return and the audits of the returns of the same taxpayer for later years are made concurrently. When the difficult, but temporary, problems arising under former revenue acts have been disposed of, there is every reason to believe that the Bureau can keep practically current with the audit of returns and the decision of claims. This is a consummation devoutly to be wished and earnestly to be sought.

The Board is against any general plan of decentralization, but announces

> . . . . the experiment of transferring a committee to some central point at a distance from Washington to hear and determine cases arising in that locality and now pending or which would come before the Committee on Appeals and Review. Many taxpayers find it necessary or desirable to come to Washington or send their representatives here to attend the hearings on their appeals. If these hearings were

conducted at or near the residence of the taxpayer, this necessity would be eliminated. If the experiment is successful, the plan will be gradually enlarged.

In his annual report presented to Congress December 6, 1922, the Secretary of the Treasury recommended that the highest surtax rate be reduced from 50 per cent to 25 per cent. He mentioned that under the present law:

> . . . . taxpayers inevitably seek every permissible means of avoiding the realization of income subject to surtax. . . . . Among the means frequently used to reduce the amounts of income subject to taxation are the following:
>
> 1. Deductions of losses on sales of capital assets, with the failure to realize on capital gains;
> 2. Exchanges of property and securities so as to avoid taxable gains;
> 3. Tax-exempt securities; and
> 4. Other avenues of escape, such as the division of property, the creation of trusts, and the like.
>
> . . . . A most serious gap in the existing revenue laws arises from the treatment of capital transactions. The law taxes capital gains and recognizes capital losses, but the taxpayer retains the initiative and refrains from realizing taxable gains while taking deductible losses. The situation is particularly serious under the revenue act of 1921, which limits the tax on capital gains to 12½ per cent, but puts no limit on the deduction of capital losses. This means that capital losses may entirely cancel real income, while capital gains will not be realized at all, or, if realized, are taxed at only 12½ per cent. Under the present system the Government is being whipsawed, and the Treasury therefore strongly urges that the existing provision as to capital gains be made to apply conversely to capital losses and that the amount by which the tax may be reduced on account of losses from the sale of capital assets should not exceed 12½ per cent of the amount of the loss. This would, to a large extent, check one of the methods widely used by taxpayers at the present time for decreasing their yearly income. The alternative is to refuse to recognize either capital gains or capital losses for income-tax purposes, and if the present situation were allowed to continue there is no doubt that it would save revenue to adopt this course. This is, in fact, the practice which has been followed in England for many years.

> The revenue act of 1921 provides, in section 202, for the exchange of property held for investment for other property of a like kind without the realization of taxable income. Under this section a taxpayer who purchases a bond of $1,000 which appreciates in value may exchange that bond for another bond of the value of $1,000, together with $100 in cash (the $100 in cash representing the increase in the value of the bond while held by the taxpayer), without the realization of taxable income. This provision of the act is being widely abused. Many brokers, investment houses, and bond houses have established exchange departments and are advertising that they will exchange securities for their customers in such a manner as to result in no taxable gain. Under this section, therefore, taxpayers owning securities which have appreciated in value are exchanging them for other securities and at the same time receiving a cash consideration, without the realization of taxable income, but if the securities have fallen in value since acquisition will sell them and in computing net income deduct the amount of the loss on the sale. This result is manifestly unfair and destructive of the revenues. The Treasury accordingly urges that the law be amended so as to limit the cases in which securities may be exchanged for other securities, without the realization of taxable income, to those cases where the exchange is in connection with the reorganization, consolidation, or merger of one or more corporations.

The Secretary states that fully tax-exempt securities now aggregate about $11,000,000,000 and are increasing at the rate of about $1,000,000,000 a year. He strongly urges the adoption of an amendment to the Constitution restricting further issues of tax-exempt securities.

Congress may pay no more attention to the Secretary's recent recommendations than it did to his suggestions of April 30, 1921—which were not embodied in the Act of November 23, 1921. If Congress does commence to amend the law, we may expect more changes than those proposed. As retroactive changes would greatly complicate completed transactions, some of the changes may be expected to be made effective on the date they become law or soon thereafter. This would follow the provision regarding wash sales which first appeared in the 1921 law.

Secretary Mellon's report also states that 167,405 income and excess profits tax claims were adjusted during the year ended June 30, 1922, of which 139,631 involving $182,371,-597.88 were allowed, and 27,774 involving $150,107,452.72 were rejected.

The admission that, of the claims filed, more than three-fourths in amount have been allowed, indicates the enormous burden the Treasury is placing upon the taxpayers who are compelled to contest unjustified additional assessments. The author has been criticized for challenging so many of the Treasury's regulations and rulings. The complete answer is the allowance of $182,000,000 of claims, or more than one-half the total claims, in one year. No mention is made of the excessive taxes which have been collected from those who are still in ignorance of their right to file claims.

If we have a soldiers' bonus we shall probably have a sales tax. Otherwise the sales tax propaganda has made little progress during the last year. Neither have the proponents of an expenditure tax made any progress.

On the whole the year 1923 should mark the peak of tax congestion. If governmental expenditures can be reasonably reduced, taxpayers should feel more comfortable after April 1, 1923. If additional 1917 taxes have not been assessed by that time and if waivers have not been signed, many tax-payers then will have time to devote to their regular businesses which has heretofore been spent in tax guessing.

During the past year there have been many important court decisions and Treasury rulings. It was necessary to eliminate some hundreds of pages from the 1922 edition of this book and to rewrite and condense much of the old text in order to discuss these recent decisions and rulings and keep the present book under 2,000 pages.

It has given me pleasure to cut out some of the extended criticisms of Treasury rulings, made possible by court decisions or new rulings reversing the Treasury's former position. As the Treasury is still deciding many other doubtful issues

against taxpayers, I look for the usual number of reversals during 1923.

A considerable part of the revision of the 1922 edition was done by my colleague at Columbia University, Professor Robert Murray Haig, to whom I am again tremendously indebted. I wish I could more adequately than by this means express my gratitude for the assistance of my partner Walter A. Staub, C.P.A., and of my assistants, J. Marvin Haynes of the bar of the District of Columbia, Hamilton Howard, and Robert Buchanan; also of Orrin R. Judd, C.P.A., Trust Officer of the Columbia Trust Company, and his assistants, Henry Major, Jr., and Joseph B. Ryan. I also express my appreciation of the authoritative material contained in the Income and War Tax Services of the Corporation Trust Company, New York, which used very freely with the company's kind permission.

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INCOME TAX PROCEDURE

1923

CHAPTER I

INTRODUCTORY

It now appears that a high tariff will be the sole product of Congressional activity in 1922 in the field of revenue legislation. This act, whatever may be its indirect effects for good or ill, will yield a relatively insignificant sum of money and the income tax promises to continue as the main support of the federal treasury.

A federal tax on gross receipts or on "turnover" may possibly be imposed, but if it is, the author believes that it will not greatly reduce the present rates of income tax. The proponents of a cash bonus to ex-service men were defeated in the last session of Congress, but they announce a continuation of their campaign, and such is the amenability of Congress to the majority of votes that successful bonus legislation in the next Congress is not an impossibility. If it comes, it is probable that a sales or turnover tax will be provided to insure the necessary revenue. In such event there will be little chance of a decrease in income tax rates. The taxpayer who is planning ahead should not underestimate the great continued burden of federal expenditure.

Yield of the income tax.—During the fiscal year ended June 30, 1922, the income and profits taxes produced slightly more than two billions of dollars, only about one-half as much as two years ago. The yield, however, is running within one per cent of the estimates made at the time of the passage of the law. The exact figures for the past five years are as follows:

1918	$2,838,999,894.28
1919	2,600,783,902.70
1920	3,956,936,003.60
1921	3,228,137,673.75
1922	2,086,918,464.85

The estimates for 1923 call for $1,775,000,000 from this source, or about 69 per cent of the total internal revenue collections.

Distribution of incomes.—The following table is made up from statistics published by the Commissioner of Internal Revenue.[1]

Number of Personal Returns, Calendar Years 1917-1920 By Income Classes

Income Classes	1917	1918	1919	1920
$ 1,000 to $ 2,000	1,640,758	1,516,938	1,924,872	2,671,950
2,000 " 3,000	838,707	1,496,878	1,569,741	2,569,316
3,000 " 5,000	560,763	932,336	1,180,488	1,337,116
5,000 " 10,000	270,666	319,356	438,851	455,442
10,000 " 25,000	112,502	116,569	162,485	171,830
25,000 " 50,000	30,391	28,542	37,477	38,548
50,000 " 100,000	12,439	9,996	13,320	12,093
100,000 " 150,000	3,302	2,358	2,983	2,191
150,000 " 300,000	2,347	1,514	1,864	1,063
300,000 " 500,000	559	382	425	239
500,000 " 1,000,000	315	178	189	123
1,000,000 and over	141	67	65	33
Total	3,472,890	4,425,114	5,332,760	7,259,944

The changes in the groups during the four years are of considerable interest. The total number of persons paying income taxes more than doubled during the period, although there was no statutory change regarding persons supposed to report. It will be noted that the entire increase occurred among the comparatively small income tax payers, the number of returns filed in every group above the $50,000 line showing an actual decrease in number in 1920 as compared with 1917.

Cost of administration.—The cost of collecting the internal revenue taxes increased from 55 cents per $100 of tax in 1920, to 72 cents in 1921, and to $1.07 in 1922. This cost is still very low. Larger sums could profitably be spent in improving the administration of the tax, in increasing the number of dis-

[1] The annual documents are entitled *Statistics of Income.*

tricts, and in making more attractive the positions in the service. A thoroughly competent administrative force, adequate in size to the task it must perform, would diminish immeasurably the present burdens involved in complying with the law.

Income Taxation in the United States

Intelligent interpretation of the existing income tax statute is facilitated by a knowledge of its history.[2] Indeed, the great number of unsettled questions of law and procedure arising under acts in force in earlier years renders a knowledge of these acts almost indispensable to most persons who use this book. Consequently it is deemed desirable to trace the development of the statute, giving sufficient information to enable the reader, with the aid of the notes on "Former Procedure," to gain a clear conception of the evolution through which it has passed.

The present federal income tax is not the only income tax being administered within the country at present, for several states utilize this source of revenue concurrently with the federal government. In fact, important as it is to the federal system, the taxation of incomes is of scarcely less interest to the several states, for it is now accepted as perhaps the most promising means of bringing about state tax reform.

State income taxation.—Because of the unhappy history of early attempts, state income taxes were viewed askance until Wisconsin, with a law introduced in 1911, demonstrated the practicability of such taxes.[3] The Wisconsin precedent was quickly followed by a number of other states, including Connecticut, which began to tax corporations on this basis in 1915,[4]

[2] For a full discussion of the history of the income tax, see Edwin R. A. Seligman, *The Income Tax* (2nd edition, New York, 1914). For a detailed description of modern income tax systems, see K. K. Kennan, *Income Taxation* (Milwaukee, 1910).

[3] Laws of 1911, Chapter 658.

[4] Acts of Conn., 1915, Ch. 292; *Bulletin of the National Tax Association*, February, 1916, page 8.

and Massachusetts, which passed a law of limited application in 1916.[5] A recent but important convert to the plan is the state of New York, which in 1917 imposed a franchise tax of 3 per cent on manufacturing and mercantile corporations and in 1919 a personal income tax. The New York franchise law was amended in 1919 to make it more general in its scope and to increase the tax to a charge of 4½ per cent of the net income of corporations as reported to the Treasury for federal tax purposes,[6] and was intended to be in lieu of all personal property taxes on those corporations. Its success paved the way for the state income tax of 1919, which imposes progressive rates on the incomes of individuals. The procedure under the New York statutes imposing income taxes on individuals and corporations is treated by the author in a separate volume entitled *New York State Income Tax Procedure,* 1921.[7]

Evolution of the federal income tax law.—The present federal income tax is a recent development. Income taxes were imposed by the national government during the Civil War, when they were considered to be indirect in their nature and consequently beyond the constitutional prohibition.[8] One was imposed also in 1894; but a year later, when tested, it was declared unconstitutional by the Supreme Court, in the famous case of *Pollock v. Farmers' Loan & Trust Company,*[9] on the ground that it was a direct tax and as such could only be imposed if apportioned according to population. Such an apportionment would have led to such monstrous economic

[5] Acts of Mass., 1916, Ch. 269; Chas. V. Bullock, *The Massachusetts Income Tax* (Boston, 1916).

[6] Modified in certain particulars.

[7] Those interested in the progress of the movement toward the taxation of income by the states will find the following articles valuable: Harley L. Lutz, "The Progress of State Income Tax Since 1911," *The American Economic Review,* March, 1920; and Alzada Comstock, "Fiscal Aspects of State Income Taxes," in the same journal for June, 1920. A more comprehensive treatment of the subject will be found in Miss Comstock's *State Taxation of Personal Incomes* (New York, 1921).

[8] Seligman, *The Income Tax,* page 430 *et seq.*

[9] 157 U. S. 429, 39 L. Ed. 759, 15 Sup. Ct. 673, 158 U. S. 601, 39 L. Ed. 1108, 15 Sup. Ct. 912.

consequences as to render a general income tax entirely unavailable as a federal financial resource. Hence a constitutional amendment had to be secured. The sixteenth amendment was passed eighteen years later. It provides that:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.

The necessary number of states had ratified by February 25, 1913, but as a matter of convenience, March 1, 1913, is referred to as the date since which Congress has had the power to tax incomes without apportionment.

But even before the acquisition of this definite authority, Congress had passed the corporation excise tax of 1909, which was an income tax in fact although not in form. The evolution of the present statute dates from that act. The 1913 law widened the application of the tax to include individuals, and the laws of 1916, 1917, 1918, and 1921 represented definite developments and refinements, the more significant details of which are briefly described in the paragraphs which follow. In general there is evident a distinct trend toward elimination of arbitrary limitations on deductions, acceptance of established business customs and institutions, and recognition of the accountant's definition of profit and income.

THE CORPORATION SPECIAL EXCISE TAX OF 1909.—The act of August 5, 1909[10] (hereinafter referred to as "the 1909 law"), provided that every corporation[11] should "be subject to pay annually a special excise tax with respect to the carrying on or doing business by such corporation . . . . equivalent to one per centum upon the entire net income over and above five thousand dollars received by it from all sources during such year. . . . ." This law was declared constitutional by

[10] 36 Stat. at L., C. 6, page 112; Comp. St. 1910, Supp. 1911, page 946; Pierce Fed. Code, Supp. §1036.

[11] "Every corporation, joint-stock company or association, organized for profit and having a capital stock represented by shares, and every insurance company."

the Supreme Court of the United States[12] on the ground that it was an excise and not an income tax within the meaning of the federal Constitution, which, by clause four of article I, section 9, declares that:

> No capitation or other direct tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken.

To all intents and purposes, except that of overcoming the constitutional difficulty, this was, of course, an income tax. The law directed that "net income" should be ascertained by deducting from gross income received certain costs, expenses paid, and losses, but in the administration of the law its requirements as to income received and expenses paid were ignored, and corporations generally paid a tax based on net income as ascertained by business practice, i.e., by deducting expenses *accrued* (whether paid or not) from income *earned* (whether received or not). The Treasury forms and regulations were designed for and applied to net income, not net receipts.

The statute was brief and general in character, leaving to the administration much latitude in interpretation. However, one important specific restriction was imposed: that upon deductions for interest paid—a feature which persisted in several later laws. The corporation could deduct interest actually paid on indebtedness only "to an amount of such bonded or other indebtedness not exceeding the paid-up capital stock of such corporation . . . . outstanding at the close of the year."[13]

Although passed late in the year, the law applied to the incomes of corporations as of the beginning of the calendar year 1909. Consequently, the period during which corporate incomes were affected by this act was four years and two months, extending from January 1, 1909, to February 28, 1913, when the 1913 law replaced it.

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[12] *Flint v. Stone Tracy Co.*, 220 U. S. 107, 55 L. Ed. 389, 31 Sup. Ct. 342.

[13] 1909 law, section 38, second.

THE 1913 LAW.—Congress, almost immediately after the ratification of the sixteenth amendment, addressed itself to the task of formulating a general income tax law, and an act was finally approved October 3, 1913, effective as of March 1, 1913 (hereinafter referred to as "the 1913 law"). In spite of its many inconsistencies and ambiguities, this law must be acknowledged to have been on the whole an "intelligent and well-considered effort."[14] It was upheld as constitutional by the Supreme Court.[15] Many of the Treasury's interpretations, however, have not been upheld by the Supreme Court.

The personal exemption was high: $3,000 for a single person, with an additional $1,000 for a married couple. The former exemption of $5,000 to corporations was, however, eliminated. The rates, compared with recent levels at least, were very low. A normal tax of 1 per cent applied to the total net income of individuals and corporations. Surtaxes, levied on individuals only, began with a 1 per cent rate when the net income reached $20,000, and increased gradually to 6 per cent on those portions of incomes which exceeded $500,000.[16] The yield the first year was approximately $71,000,000.

Eagerness to prevent evasion and to secure a large yield was responsible for several restrictions upon deductions—restrictions which caused endless complications and irritations. Thus, individuals in deducting losses could subtract only those which were incurred "in trade." Deductions for depletion of mines, whether owned by individuals or corporations, were restricted to 5 per cent of the value of the output. Corporations were forced to pay tax on dividends received from other corporations whether or not the other corporations were subject to income tax. The restriction upon interest paid by corporations, mentioned as a characteristic of the 1909 law, was continued by the 1913 law in another form. A corpora-

[14] Seligman, *The Income Tax*, page 703.

[15] *Brushaber v. Union Pacific R. R. Co.*, 240 U. S. 1, 60 L. Ed. 493, 36 Sup. Ct. 236.

[16] For a detailed table of the rates, see Chapter IX.

tion could now deduct interest on its indebtedness "to an amount of such indebtedness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year."[17]

The law granted to corporations the privilege of accounting on the basis of fiscal years rather than calendar years, but withheld it from individuals. Finally, the act adopted the system of collection at the source, which had proved so effective in preventing evasion in Great Britain. This device, however, was the occasion of so great complaint from those charged with the duty of withholding the tax that after four years' experience it was abandoned in 1917.

THE 1916 LAW.—Three years after its establishment the income tax was called upon to produce a much larger revenue. Because of the effect of the European War, receipts from import duties had diminished, while the expenditures of the federal government had greatly increased. To assist in meeting this emergency, income tax rates were raised. The normal rate applying both to individuals and corporations was made 2 per cent and the surtax rates upon individual incomes were made to range from 1 to 13 per cent. The lowest surtax rate applied as before upon income immediately above $20,000, and the highest rate on the portions of income exceeding $2,000,000.[18]

This law, passed September 8, 1916 (hereinafter referred to as "the 1916 law"), was made applicable to income received after January 1, 1916. Consequently the 1913 law was effective as to income received during a period of two years and ten months, from March 1, 1913, to December 31, 1915.

The 1916 law, although a re-enactment of the 1913 law, was entirely recast in form and changed in a number of

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[17] With several provisos including those designed to cover the cases of corporations with no capital stock and of corporations with indebtedness secured by collateral which was subject to sale as stock in trade. 1913 law, G (b).

[18] For a detailed statement of the rates, see Chapter IX.

particulars. The changes for the most part had the effect of making the statute clearer and more practicable. March 1, 1913, was now definitely set as the date from which appreciations or depreciations of property values were to be measured for purposes of the tax. Stock dividends were specifically included in taxable net income,[19] whereas the 1913 law had been silent on this point. Proceeds of life insurance policies transferred upon the death of the insured were declared to be exempt only when paid to individual beneficiaries.

Deductions were liberalized in two important particulars. Losses in transactions entered into for profit but not connected with an individual's trade or business were made allowable deductions, "to an amount not exceeding the profits arising therefrom."[20] Again, the arbitrary 5 per cent limitation upon depletion allowances, a feature of the 1913 law, was eliminated and the way was opened for the full deduction of items of this character.

The 1916 law continued in effect for two years from January 1, 1916, to December 31, 1917. On October 3, 1917, the war income tax act was passed and had the force of a supplement to the 1916 law, for the year 1917.

THE 1917 LAW.[21]—Although the 1916 law yielded about 360 millions, such a sum was insufficient as the contribution from this source toward the expenses caused by our entry into the war. Consequently an act was passed on the fourth anniversary of the passage of the 1913 law, October 3, 1917 (hereinafter referred to as "the 1917 law"), which raised the income tax rates to a level never before approached in the history of civilization.[22] Thus after a

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[19] For the decision declaring stock dividends non-taxable under this law, see Chapter XXVIII.

[20] 1916 law, section 5, fifth.

[21] For a complete analysis, see *Income Tax Procedure*, 1918.

[22] Seligman, "The War Revenue Act," *Political Science Quarterly*, March, 1918, page 18.

very short period of administrative experience the income tax was put to the most severe test which a government ever had the courage to impose. It is greatly to the credit of both taxpayers and the Treasury that the system has stood the test as successfully as it has.

This 1917 amendment was effective as of January 1, 1917, and remained valid for the period of one year.

In form, the 1917 law was an amendment to the 1916 law, the object apparently being to make possible the speedy repeal of the former without disturbing the law proper. This policy must now be declared to have been a mistaken one, for the confusion and difficulty caused by operating under the 1916 law, with its elaborate amendments, including two separate schedules of rates and two sets of personal exemptions, more than counterbalanced any advantages of the plan.

In addition to the 1916 taxes, a new normal tax of 2 per cent was imposed on individuals and a new 4 per cent rate on corporations, making the total normal rate 4 per cent, except on the income between $1,000 and $2,000, on which the rate was 2 per cent, and making the corporation tax rate 6 per cent. The surtaxes on individual incomes, which were to be levied in addition to the surtaxes existing under the 1916 law, ranged from 1 to 50 per cent and applied to all persons with taxable incomes of $5,000 or more. Consequently a tax rate of 67 per cent was applied to all taxable income accruing to an individual in excess of $2,000,000—2 per cent normal and 13 per cent surtax under the 1916 law, plus 2 per cent normal and 50 per cent surtax under the 1917 law.[23] For the purposes of the 1917 amendment the personal exemption was reduced from $3,000 to $2,000 for married couples and to $1,000 for single persons, and, for the first time, a deduction of $200 was permitted for each dependent.

Various other changes were made in the law. The system of collection at source was virtually abandoned and a plan of

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[23] For a detailed statement of rates, see Chapter IX.

"information at source" was substituted, thus removing a prolific source of irritation and embarrassment. The deduction of gifts by individuals to charitable, religious and educational institutions was permitted to an amount equal to 15 per cent of the net taxable income as calculated without making this deduction. On the other hand, limitations were imposed on several deductions, income and excess profits taxes being made non-deductible, as was interest on money borrowed for the purchase of tax-exempt securities. For the purpose of the new 4 per cent tax on corporations, however, permission was given to deduct the dividends on stock in other corporations.

The high rates established as the result of the passage of the 1917 law were, of course, expected to be temporary. To prevent corporations from avoiding the heavy 1917 tax through the simple device of postponing declarations of dividends until a period of lower rates arrived, Congress wrote a provision into the law which prescribed that dividends should be "taxed to the distributee at the rates prescribed by law for the years in which such profit or surplus was accumulated by the corporation."[24] The years of accumulation could not be arbitrarily selected by the corporation and, under the Treasury interpretation, the precise position of the distributions in the surtax scales of the previous years was determined by adding them to the net income of the current year. This provision was repealed by the 1918 law,[25] but in the short period during which it was in force it greatly complicated the administration of the law. Nevertheless it was essentially a just provision, even though the prescribed method of applying the rates is open to criticism, and, having enacted it, Congress should have evolved some method of safeguarding the interests of the corporation which acted under it in good faith.

In 1917, also, excess profits taxes were introduced into the federal system. A law of this nature was passed March 3,

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[24] 1917 law, section 1210.

[25] Except in the case of certain stock dividends. See Chapter XXVIII.

1917, but was replaced by the act of October 3, 1917, which itself imposed a heavy levy on supernormal profits as judged by the standard of invested capital. A full treatment of this act as well as of its successor of 1918 will be found in the author's *Excess Profits Tax Procedure,* 1921.[26]

THE 1918 LAW.—The need for still greater revenues to meet the growing demands of the war, and an anxiety on the part of the Treasury to be relieved of some of the responsibility it had assumed by its liberal interpretation of the excess profits tax law of 1917, united with other causes to bring about a new Revenue Act for 1918. The law (hereinafter referred to as "the 1918 law") although not finally approved until February 24, 1919, affected income arising after January 1, 1918. It remained in force until the effective date of the Revenue Act of 1921, which, for most of the provisions, was January 1, 1921.

The 1918 law was a complete statute, and replaced entirely the 1916 and 1917 acts, which had existed concurrently during 1917. It was a comprehensive law which imposed a new version of profits tax, certain luxury taxes, and other internal revenue charges. Its text alone covered no less than 106 pages in the official edition. The technical task of drafting was well done, the language being for the most part clear, and the arrangement convenient; the form, in general, was greatly superior to that of the earlier laws.

Rates applied to 1918 income exceeded even the record schedules of 1917. The normal rate and the corporation tax rate both were made 12 per cent, with a reduction to 6 per cent on the first $4,000 of the taxable income of a citizen or resident of the United States. These rates stood only until January 1, 1919, when the normal rate applying to the taxable income of a citizen or resident of the United States became 8 per cent (4 per cent on the first $4,000) and

[26] Supplements to this volume appear in *Income Tax Procedure,* 1922, pages 1564-1670, and in Appendix A of this book.

the corporation tax rate dropped from 12 to 10 per cent. Thus there reappeared a discrimination of 2 per cent against corporate incomes similar to that which obtained in the year 1917.

Surtaxes on individual incomes ranged from 1 to 65 per cent, the highest rate applying to portions of income exceeding $1,000,000. The maximum total rate in 1918 was, consequently, 10 per cent higher than that which obtained in 1917, and the higher normal rate[27] and the steeper progression made the tax much heavier upon moderate incomes than the previous one.[28] The maximum total rate applied to 1919 and 1920 incomes was 73 per cent.

The 1918 law, while sufficiently complicated, was nevertheless more simple and equitable than its predecessor. One set of rates and personal exemptions replaced the double set in force in 1917, and many of the limitations and restrictions which, since the beginning, had hedged about the various deductions and caused endless confusion and complication, were removed. Under the 1918 law the provision permitting an individual to deduct losses not incurred in trade was liberalized. For the first time the individual was required to report upon the basis of his annual accounting period, even though that period did not coincide with the calendar year. Affiliated corporations were required to file consolidated returns.[29] Depreciation allowances were made more liberal. Depletion in the cases of mines and gas and oil wells was placed upon a very generous basis, with a special and rather artificial method provided for establishing "discovery value" in the case of properties owned by prospectors and "wild-catters." Special provision was made for charging off reasonable amortization on equipment which contributed to the prosecution of the war. Corporations for the first time were relieved of the

[27] In the case of earned incomes, the normal rate of 12 per cent was actually no higher for individuals than in 1917, because of the application in that year of the 8 per cent excess profits tax to professions and occupations in addition to the normal income tax of 4 per cent.

[28] For a detailed table of rates, see Chapter IX.

[29] Section 240.

arbitrary limitation on deductible interest, which had been in force in some form since 1909, and of the discriminating tax on dividends received from other corporations. Income and excess profits taxes paid to other jurisdictions upon income arising therein were, under certain conditions, allowed as credits against the tax. A specific credit of $2,000 was granted corporations. The rule allocating dividends to the year earned, established in the 1917 law, was abandoned.[30]

As in the case of previous laws, partnerships were not taxed as such, the individual members, instead, being made liable on their distributive shares of the partnership income. The 1918 law introduced an innovation by putting in the same category with partnerships certain corporations whose income was "to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor" (section 200). At the end of the taxable year the undistributed net income of each of these "personal-service corporations" was assigned for taxation to the stockholders in proportion to their holdings. They were relieved of the federal profits taxes, which otherwise would have attached because of the corporate form of the enterprise. Under the 1921 law this class of personal service corporations was abandoned, effective December 31, 1921.

The Revenue Act of 1921

Due to the insistence of business men that the taxes levied by the 1918 law were unduly burdensome and were not well fitted to post-war conditions, both political parties during the presidential campaign of 1920 committed themselves to a revision of federal taxation. The Revenue Act of 1921,

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[30] Except in the case of certain stock dividends. See Chapter XXVIII.

approved November 23 of that year, was the result of the pledge of the Republican Party. Although it came from the House of Representatives in the form of a series of amendments, it finally emerged from Congress as a complete new law. However, it follows the phraseology of the 1918 law so closely that, in spite of numerous and fundamental changes, it is fair to describe it as essentially a rewritten draft of the 1918 law.

The provisions of the Revenue Act of 1921 (hereinafter referred to as "the 1921 law") are treated fully in the chapters which make up the body of this book, but it is desirable at this point to sketch briefly its main outlines and to make some general observations and criticisms.

Modifications made by the 1921 law.—The effective date of the new law is, for most purposes, January 1, 1921. Many of the most radical changes, however, did not come into force until one year later, January 1, 1922. This includes the sections which abolish the excess profits tax and the personal service corporation, increase the corporation tax rate, and establish the new class of "capital gains and losses."

In spite of what many considered to be a definite pledge, and due largely to the influence of the "agricultural bloc," Congress declined to repeal the profits tax for 1921 but did abolish it thereafter. With it disappeared the personal service corporation, which was, of course, a mere incident of profits taxation, devised to exclude corporations of a particular type from the application of such taxes. With the elimination of the excess profits tax, the income tax rate on corporations rose from 10 to 12½ per cent. The change in the rate caused corporations which made only moderate profits, to pay higher taxes, but the total tax burden on corporate income was considerably lessened thereby.

At the same time that these changes in the corporation income taxes were made, the surtax rates on individual incomes were reduced. A full table of the rates, old and

new, is presented in Chapter IX. It will be noted that the change affects small taxpayers as well as large ones. The maximum rate was reduced but still remains very high—50 per cent, as compared with the maximum rate of 65 per cent under the 1918 law. The new maximum rate applies to all income in excess of $200,000. The old rate, which applied to the increment of income next above $200,000, was 60 per cent. Under the new scale, surtaxes do not begin until the $6,000 point is reached and are 1 per cent for incomes between $6,000 and $10,000. Under the old scale, the surtaxes began at $5,000 and mounted by more rapid steps. These changes, however, were not expected to reduce, materially, the total yield of the individual income tax.[31]

The most revolutionary change in the new law was the establishment of the new division of income to be known as "capital gains." Beginning January 1, 1922, profits made by individuals from sales or exchanges of property "held for profit or investment," are subject to a maximum rate of 12½ per cent instead of the regular rates which, since that date, range as high as 58 per cent (normal plus surtaxes).[32] The reason for the adoption of some such provision as this is plain, whatever one may think of this particular method of meeting the situation. As everyone knows, many sales of property which had greatly increased in value since March 1, 1913, had been postponed or entirely blocked by the unwillingness of prospective sellers to take profits which would immediately become subject to heavy surtaxes in the year of realization. The solution adopted was practically to wipe out the offensive surtaxes on profits from this class of transactions.

It is too early to predict the full effect of the provision. In some cases it is working beneficially; in general it com-

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[31] See page 3.

[32] 1921 law, section 206. This is hedged about by several restrictions. See Chapter XXII.

plicates the procedure and discriminates against earned income instead of in favor of it. It is being taken advantage of by those who are able to work out plans of waiving interest and dividends and substituting therefor non-interest-bearing and other forms of securities wherein the increment in value falls within the statutory definition of capital gain.

The advantage to the investor in property conferred by the "capital gain" section is greatly accentuated by the provisions of the section prescribing the basis for determining gain or loss[33] which became effective as of January 1, 1921. Not only does this section adopt the so-called Frierson rule (which, in the case of property purchased before March 1, 1913, states that a profit or loss must be shown when comparison is made with original cost and be limited to the portion thereof which accrued after March 1, 1913), but it also liberalizes the definition of the closed transaction. The law now states positively that no gain or loss on exchanges of property for property shall be recognized unless the property received in the trade "has a readily realizable market value." Even though it has a readily realizable market value, the gain need not be accounted for at the time of exchange in certain cases. This is one:

> . . . . When any such property held for investment or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use. . . . .

Other exceptions, covering cases of corporate reorganizations and sales of property to corporations, make it unnecessary to report many gains which have heretofore been subject to tax at the time the transaction was performed.

The new law took an important forward step when it broke away from the practice of refusing to permit a business loss in one accounting period to offset income of another. Section 204 (effective beginning 1921) permits, within

[33] Section 202.

certain restrictions, a net loss from business suffered in one year to be offset against any net income realized in the two next succeeding years. In other words, such losses may now be used to blot out subsequent gains, but losses are "outlawed" for this purpose after the expiration of two years. This change goes far toward rendering unnecessary any averaging device such as has been often urged as a means of making the income tax more equitable.

In addition to the reduced surtax rates, effective in 1922, the personal exemptions were made more liberal, the changes affecting the 1921 returns. In the case of a married person or a head of a family whose income does not exceed $5,000, the exemption was increased from $2,000 to $2,500.[34] The allowance for each dependent was raised from $200 to $400.

A new provision regarding gifts requires the recipient, when he disposes of the gift, to account for the gain in the value of the gift in the hands of the donor before he parted with it, together with any subsequent appreciation in value. Another provision aims to prevent "wash sales" to establish losses. Also, the law at last recognized reserves for bad debts as proper deductions. The Liberty bond exemptions were consolidated and simplified appreciably by another section.

Since January 1, 1922, personal service corporations have been taxed as ordinary corporations. The law includes a saving clause providing that if the Supreme Court declares invalid the method of taxing such corporations under the 1918 law, they shall be taxed as corporations from January 1, 1918. The basis of taxation of insurance companies was radically changed, as was that of businesses drawing the major portion of their income from sources within the possessions of the United States. Section 264 was added in 1922, and deals with the taxation of corporations organized under the China Trade Act of 1922.

Affiliated corporations were given the option, after January

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[34] For a full statement, see 1921 law, section 216 (c).

1, 1922, of filing separate or consolidated returns. A clause was also inserted validating the requirement of consolidated returns (including even partnerships) under the 1917 law.

A Tax Simplification Board has been set up under the new law to investigate the procedure of the Bureau of Internal Revenue and to make recommendations for its simplification.

Congress, realizing that the Treasury should not be allowed to withhold taxes overpaid, without granting compensation for the delay, directed the Treasury to pay interest on taxes refunded.

Other changes in the law included a limitation of time for the filing of amortization claims; a provision that returns must be filed in all cases where an individual's gross income exceeds $5,000; a limitation on the deduction of interest paid to carry Liberty bonds; permission to deduct business traveling expenses in full; and a change in the limitation periods for amended returns. Finally there were important changes in administrative features, such as the sections permitting binding agreements between the Treasury and the taxpayer, changing the procedure with reference to appeals, and authorizing the Treasury to defer collection in cases of undue hardship.

All in all, the 1921 law contains much that is good but also much which is open to serious criticism. Undoubtedly progress is being made toward a more satisfactory statute from the technical point of view, but much still remains to be done. Perhaps the most damning indictment which can be urged against the new statute is that it has increased rather than decreased the technical difficulties of arriving at net income. Instead of simplifying, it has complicated the problem and it has done so in order to achieve certain objects which in the end are not likely to commend themselves to the people of the country generally. Certainly to set up a new differentiation of income in order to discriminate against earnings as compared with property profits,

does not constitute real progress toward a permanently satisfactory solution of the problem.

Tax-exempt securities.—The high surtaxes on income have been the object of bitter attack on the ground that they are operating to force capital into tax-exempt securities. The relative attractiveness of tax-exempt municipal and state bonds has aroused those who are interested in private business undertakings which are dependent upon borrowed capital, and they demand either the exemption of interest on their securities or the elimination of all exemptions.

The plain facts are, of course, that the surtax rates are unreasonably high and that the amounts of tax-exempt securities available for investment are unreasonably large. The reduction of the surtax rates to the more moderate levels of the 1921 law has helped the situation somewhat. At the same time the problem of the tax-exempt bond is being vigorously attacked, the movement having the full approval of the Treasury and of the administration. Active support should be given by all to the proposed constitutional amendment permitting the states and the federal government to tax the interest on all future issues. Certainly there is no solution in the direction of further extension of the principle of exemption. Tax-exempt securities must be reduced in amount, not increased. Unless this can be accomplished, the whole future of income taxation *at progressive rates* is seriously threatened.[35]

Differentiation between earned and unearned income.—There is a growing sentiment in favor of relatively heavier taxation of unearned income. Such a change was recommended by the Treasury for the 1918 act. Largely because of the administrative difficulties involved, the suggestion was not adopted at that time. The question has been made much

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[35] See *Income Tax Procedure*, 1922, page 34.

more important by the passage of the 1921 act, with its liberal provisions relating to capital gains and the closed transaction.

Some maintain that the state and local property taxes operate so as to establish a sufficient discrimination against funded incomes. There is, of course, some force in this contention. However, it must be remembered that the burden of these property taxes usually falls heavily upon real estate only, because, while nominally subject to tax, personal property for the most part escapes. Therefore, while a differentiation in favor of earned income might tend to increase the burden of taxation resting on real estate, any such increase should, in cases where it results in an inordinately high rate on real estate, be distributed over a wider base through a general reform of the methods of state and local taxation.

Perhaps the greatest difficulty in differentiating between earned and unearned incomes is to distinguish between income derived by an individual or partnership from the conduct of a business enterprise, and the dividends received by stockholders interested in a corporate enterprise engaged in the same kind of business. This problem will be solved if some means can be devised whereby those closely associated with the management of a corporation, as the officers and directors of a close corporation, can be deemed to be in active business and entitled to the rate of tax applicable to earned incomes.

This distinction between "lazy" and "industrious" incomes, to use Gladstone's famous terminology, has been recognized in Great Britain since 1907 and appeals powerfully to the British people's sense of justice. There the differentiation is applied in the case of smaller incomes only, which materially simplifies the administrative problem. Inland Revenue officers consider this a simple distinction to establish in practice and the people generally believe it to be sound in principle.

Retroactive taxation.—The Revenue Act of 1918 was not approved by the President until February 24, 1919, two

months after the close of the year whose incomes it subjected to tax. President Harding signed the 1921 law on November 23, 1921, three months earlier than President Wilson signed the 1918 law, but still at least eleven months late. That the law is not invalidated by this tardiness appears to be beyond question,[36] but its practical economic wisdom is quite another matter. It is of the highest importance that taxpayers should know in advance what their tax rates are to be. It is also important that they should not be put to serious inconvenience by being asked to master radical changes in complicated statutes within a few weeks before the returns are due. Congress has shown a strong disposition to postpone action on revenue measures and to take advantage of the fact that retroactive legislation of this type is not unconstitutional. In the presence of an overwhelming emergency, such as may be occasioned by rapidly changing conditions during a war, such legislation may be excused, but under present conditions there is no adequate reason why legislation affecting a current year's income should not be completed before the opening of the year.

For argument against retroactive application, see I-38-511; Sol. Op. 1105.

The Plan of the Book

Two features of the book's arrangement should be emphasized. One is the treatment of former procedure. Because of the large number of returns for previous years which are as yet unaudited by the authorities, it is deemed desirable to include in footnotes the facts concerning the law and procedure which formerly obtained wherever important changes have

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[36] Decision. It is clearly . . . . constitutional as well as expedient, in levying a tax on profits or income, to take as the measure of taxation the profits or income of a preceding year. To tax is legal, and to assume as a standard the transactions immediately prior is certainly not unreasonable, particularly when we find it always adopted in exactly similar cases. (*Drexel & Co. v. Commonwealth*, 46 Pa. St. 31.)

See also *Brushaber v. Union Pacific R. R. Co.*, 240 U. S. 1, 36 Sup. Ct. 236, 60 L. Ed. 493.

For a full discussion as to the extent to which the laws of 1913 to 1918 were retroactive, see *Income Tax Procedure*, 1919, pages 30-32.

been made. This makes it possible for the book to serve as a guide when questions arise in regard to old returns.

The second feature to which attention should be drawn is the policy of quoting exactly from law and regulations all material of importance in considering questions connected with the preparation of returns. Since the construction often turns upon a single word or punctuation point, it seems to the author important to make the precise official language available in convenient and easily recognizable form. The source of all material quoted in the text is plainly indicated, the excerpt being labeled "law," "regulation," "decision," etc., as the case may be. It should be noted that regulations quoted in the text are taken from official Regulations 62 unless otherwise specified. A quoted regulation bearing as a reference merely an article number is to be considered as coming from this source.

Early in 1920 the Treasury began the issue of a series of official weekly bulletins containing decisions, opinions and rulings by the Attorney General, Solicitor of Internal Revenue, and the Committee on Appeals and Review and many "office" decisions as currently handed down. Rulings issued prior to 1920 have been edited and published also, as Cumulative Bulletin No. 1. All of this material has been carefully reviewed. The more important interpretations are quoted in full.

The following abbreviations are used by the Treasury in these bulletins:

Ct. D.	Court Decision
T. D.	Treasury Decision
Op. A. G.	Opinion of Attorney General
S.	Solicitor's Memorandum
O. or L. O.	Solicitor's Law Opinion
Sol. Op.	Solicitor's Opinion
T. B. R.	Advisory Tax Board Recommendation
T. B. M.	Advisory Tax Board Memorandum
A. R. R.	Committee on Appeals and Review Recommendation

A. R. M.	Committee on Appeals and Review Memorandum
O. D.	Office Decision
Mim	Mimeograph letter
C. B.	Cumulative Bulletin (No. 1 covers 1919; No. 2, January-June, 1920; No. 3, July-December, 1920; No. 4, January-June, 1921; No. 5, July-December, 1921. A new series of numbers was commenced with the Cumulative Bulletin covering the period January-June, 1922, which is known as No. I-1.)
I. T.	Income Tax Unit
E. T.	Estate Tax Division
C. S. T.	Capital Stock Tax Division
A. B. C., etc.	The names of individuals
M. N., X. Y. Z., etc.	The names of corporations, places, or businesses, according to context
x.	Is used to represent a certain number and when used with the word "dollars" represents a sum of money.

Rulings issued prior to January 1, 1922, were cited by the Treasury as 1-21-1369, meaning Bulletin No. 1 of 1921, Ruling No. 1369. A new series of bulletins has been issued for 1922 in which the method of reference is different. Rulings are now quoted as I-33-27, meaning Volume I (of the new series) Bulletin No. 33, Ruling No. 27.

The author has indexed all bulletin rulings issued prior to July, 1922, to the pages of the Cumulative Bulletins upon which they appear. Thus C. B. 3, page 23; O. D. 587, shows that the quotation is from Office Decision 587, which will be found in full on page 23 of Cumulative Bulletin No. 3 (July-December, 1920). Rulings issued subsequent to July 1, 1922, are referred to by number, as the Cumulative Bulletin for July-December, 1922, will not be published until some months after December 31, 1922.

A classified index to all rulings has been incorporated in this volume.

All new rulings of any importance relating to the excess profits tax and published during 1922 are presented in an

appendix to this volume. This appendix together with the similar one included in *Income Tax Procedure,* 1922, comprise a complete supplement to the separate volume, *Excess Profits Tax Procedure,* 1921.

The chapter on the federal estate tax included for the first time in last year's edition is retained, and the chapter on the federal capital stock tax has been revised and is again included in this volume.

PART I

APPLICATION AND ADMINISTRATION

CHAPTER II

APPLICATION OF THE LAW

The tax is imposed upon "net income," a term minutely described in the law. In the case of individuals it means the gross income, which includes earnings from personal services, business and trades, profits from sales of property, interest, rents, royalties, dividends, etc., less deductions for expenses, losses, interest, taxes, depreciation, etc.[1] The surtax, which commences at an amount in excess of $6,000,[2] is calculated upon the total net income as thus established. To determine the basis for the 8 per cent normal tax of an individual, there are certain deductions (or "credits," as they are called) for dividends, interest on Liberty bonds, etc., the personal exemption of $1,000, $2,000, or $2,500, and the exemption for dependents. The first $4,000 of the amount so determined is subject to a normal tax of only 4 per cent in the case of citizens or residents of the United States.

The gross income of corporations includes the same items as for individuals, but the deductions are not quite the same.[3] Moreover, there are certain subtractions from corporate incomes which are allowed under the title of "credits." For a full discussion of credits, see Chapter XV. The net income of corporations is taxed at a flat rate of 12½ per cent.[4]

The various types of taxable income included under the provisions of section 213, and the allowable deductions permit-

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[1] Section 214.

[2] Raised from $5,000 where it stood in 1921. See Chapter IX.

[3] The chief differences are deductions which are permitted individuals for losses not connected with business or trade, and for donations. Dividends are deducted from gross income in arriving at the net income of corporations, but are considered as credits (for normal tax only) against the net income of individuals.

[4] In 1921, corporations were subject to an income tax of 10 per cent and in addition paid the excess profits tax. See Chapter IX.

ted by sections 214 and 234, are discussed in detail in the series of chapters which constitute Parts II and III of this book. Exemptions are treated in Chapter XV. The problems of the special classes of taxpayers, such as non-resident aliens, fiduciaries, etc., are presented in Part IV.

The law states that the tax shall be imposed upon the net income "of every individual" and "of every corporation."[5] As pointed out above, the position of corporations under the law is different from that of individuals. Corporations are taxed 12½ per cent on their net income. Individuals are taxed at progressive rates, but any dividends received from corporations which have already paid this tax are exempt from the normal tax. Partnerships are not taxed directly as such. The individual partners account for their partnership profits in their personal returns, the partnership submitting a return for information purposes only.

The difference of treatment, thus roughly sketched, makes it necessary to draw a sharp line of distinction between incorporated and unincorporated business—between the individual and partnership, on the one hand, and the corporation on the other.[6] As a matter of fact, of course, no such sharp line actually exists, the zone between the partnership and the corporation being filled with various peculiar types of business ownership organizations, which vary from one another by almost imperceptible degrees. The attempt to draw a sharp line in this zone has given rise to many questions and necessitates extended treatment here.

In the past, the problem has been complicated by a feature of the law which treated certain types of corporations—personal service corporations—as though they were not corporations at all but were partnerships. This practice ceased with the abolition of the excess profits tax as of December 31, 1921.

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[5] Sections 210, 230.

[6] For the purpose of establishing liability for returns, it is necessary to establish the existence or non-existence of a partnership. Under the 1917 law, there were more substantial reasons for this distinction.

For convenience, all types of taxpayers will be discussed under the three groups mentioned in the regulations.

REGULATION. The statute recognizes three chief classes of persons, to wit, individuals, partnerships, and corporations. . . . . (Art. 1501.)

Individuals under the Revenue Law

The statute offers no formal definition of the term "individuals." The senses in which the words "person" and "taxpayer" are used should be carefully noted:

LAW. Section 2. (1) **The term "person" includes partnerships and corporations, as well as individuals.**

Section 2. (9) **The term "taxpayer" includes any person, trust or estate subject to a tax imposed by this act.**

Under certain conditions a minor is recognized as an individual under the law and is required to file returns. See page 101.

Partnerships under the Revenue Act

The law does not define precisely what organizations shall be considered as partnerships. The regulations and rulings of the Treasury also furnish no comprehensive definition, but following the statutes of the states in which the cases arise, as well as the principles of the general law of partnerships, they do specify certain forms of organizations which shall or shall not be so designated.

Ordinarily when two or more persons are associated together for the purpose of conducting a business for profit, they are deemed to constitute a partnership.[7]

Not all organizations bearing the title of partnership are considered to be such for purposes of the Revenue Act.[8]

[7] Those persons are partners, who contribute their property or money to carry on a joint business for their common benefit, and who own and share the profits thereof in certain proportions. *Meehan v. Valentine*, 145 U. S. 611, 36 L. Ed. 835.

[8] Moreover, under a clause which applied until December 31, 1921, certain corporations were not considered to be such for purposes of the Revenue Act. For a discussion of these so-called "personal service corporations," see *Income Tax Procedure*, 1922, Chapter XXIV.

Thus, certain types of limited partnerships are considered to be corporations.

Domestic partnership defined.—

Regulation. A domestic . . . . partnership is one organized or created in the United States, including only the States, the Territories of Alaska and Hawaii, and the District of Columbia, and a foreign . . . . partnership is one organized or created outside the United States as so defined. . . . . The nationality or residence of members of a partnership does not affect its status. A partnership created by articles entered into in San Francisco between residents of the United States and residents of China is a domestic partnership. . . . . (Art. 1509.)

Partnerships distinguished from mere joint enterprises and joint adventures.—Generally speaking, an individual assumes greater financial responsibilities when he is a member of a duly constituted partnership than when he is merely associated with one or more other persons for the purpose of carrying out specific contracts or engaging in the performance of isolated transactions. When creditors are deceived, or apt to be deceived, by apparent joint liability, it is just that the elements of partnership obligations should be read into otherwise indefinite relationships. When there is no deception and no intention to form general partnerships, the intention of the individuals should prevail.

Forms of joint enterprises considered to be partnership.—In the second paragraph of the following ruling, the Treasury enumerates certain points which are taken into account in determining the status of an enterprise.

Ruling. A, and B, his wife, founded a hospital under an oral agreement that it was to be their joint business. The original investment of approximately *x* dollars was contributed by B. The building for the enterprise is owned jointly by A and B and the balance of the property used in the business is owned by them equally. The profits arising from the enterprise over and above living expenses have been placed back in the business and the losses, if any, are charged to the enterprise. The powers and responsibilities are equally divided, each party having authority to draw checks, receive payments, and per-

form similar acts. Neither party may dispose of his or her interest without the consent of the other.

Since there is an equal sharing of the profits and losses, a community of interest, a mutual agency between the parties to the agreement, and an intention to form a partnership, and since a wife may enter into a partnership with her husband in the particular State, the business conducted by A and B is held to be a partnership for the purpose of Federal taxation. (C. B. I-1, page 1; I. T. 1151.)

Because most of the controlling elements were present, the foregoing ruling is sound.

Six individuals purchased trees jointly for the purpose of cutting and selling logs. They did business as an unincorporated company and filed a tax return as a partnership on a fiscal year basis. The management of the business was in the hands of one individual. It was held that it was a partnership and not a joint venture or association.[9]

Forms of joint enterprises not considered to be partnerships.—There are many instances of joint enterprises in which attempts are made to deal with them as if they were partnership entities, although the necessary elements of the partnership relation are lacking. From the point of view of the federal taxation the legal status is not of great importance except in so far as the year 1917 may be affected. Therefore the following regulation is now of little importance.

Regulation. Joint investment in and ownership of real and personal property not used in the operation of any trade or business and not covered by any partnership agreement does not constitute a partnership. Co-owners of oil lands engaged in the joint enterprise of developing the property through a common agent are not necessarily partners. In the absence of special facts affirmatively showing an association or partnership, where a vessel is owned by several individuals and operated by a managing owner or agent for the account of all, the relation does not constitute either a joint-stock association or a partnership. The participation of two United States corporations in a joint enterprise or adventure does not constitute them partners. (Art. 1507.)[10]

[9] I-33-455; I. T. 1418.

[10] [Former Procedure]

Ruling. Article 1507, Regulations 45 (revised) applies to situations arising under both the Revenue Ant of 1917 and the Revenue Act of 1918. (C. B. 2, page 11; O. D. 411.)

A joint venture entered into by agreement between a United States corporation and an individual was held not to be a partnership.[11]

RULING. Contributions of labor and capital and an agreement to share equally in the product grown do not of themselves and in the absence of the element of mutual agency as well as an intention to form a partnership constitute a partnership for Federal income-tax purposes. (C. B. I-1, page 3; Digest I. T. 1186.)

The Treasury has held in another ruling[12] that the one fact that the net losses, if any, were to be borne by one of the parties is insufficient to disqualify the enterprise as a partnership.

The Treasury has also stated, in a case in which several persons contributed severally to a fund used to develop and operate an oil field, with the agreement that they were to share *pro rata* in the profits, that participation in the profits and the use of the names of the parties in directories and in joint bank accounts, is not sufficient, in the absence of intent to form a partnership, to constitute such an organization.[13]

Several individuals were the subscribers to a syndicate agreement of which another individual was the manager.

RULING. . . . . Held, that these agreements constituted the principals joint owners in a joint venture. As such each is taxable in his individual capacity on income from that source. Each subscriber has an interest in the joint account of such a nature that a pro rata profit or loss inures to him on each completed transaction evidenced by a purchase and sale of stock at a higher or lower price as the case may be.

Dividends upon the stock held by the syndicate should be reported in the taxpayer's return for the year in which the dividends were declared and collectible in the proportion which his interest bears to the total amount of stock held by the syndicate. . . . (C. B. I-1, page 2; I. T. 1156.)

The foregoing ruling holds that the net income of subscribers should be based upon closed transactions. These no

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[11] C. B. 1, page 9; O. D. 96.
[12] C. B. 2, page 11; S. 1361.
[13] C. B. 5, page 254; Sol. Op. 117.

doubt are subject to deductions for expenses. It would seem necessary for the managers to render periodical reports to subscribers in order that the latter may return the aggregate net income for the taxable periods; otherwise excessive profits might be returned.

Two individuals purchased, fed, and sold cattle in 1917. One was in fact merely the agent of the other. It was held that it was not a partnership.[14]

Limited partnerships not always classed as partnerships.— The Treasury draws a distinction between different types of limited partnerships, regarding one type as corporations and the other type as partnerships for income tax purposes.[15]

TYPES RECOGNIZED AS PARTNERSHIPS.—

REGULATION. So-called limited partnerships of the type authorized by the statutes of New York and most of the States are partnerships and not corporations within the meaning of the statute. Such limited partnerships, which can not limit the liability of the general partners, although the special partners enjoy limited liability so long as they observe the statutory conditions, which are dissolved by the death or attempted transfer of the interest of a general partner, and which can not take real estate or sue in the partnership name, are so like common law partnerships as to render impracticable any differentiation in their treatment for tax purposes. Michigan and Illinois limited partnerships are partnerships. A California special partnership is a partnership. (Art. 1505.)

RULING. The M Company, a partnership organized under the laws of the State of Pennsylvania, desires to be classed for Federal tax purposes as a limited partnership of the type mentioned in article 1506 of Regulations 45.

The said partnership differs from the type of partnerships provided for in the Pennsylvania statute in that the word "limited" does not appear in the firm name, yearly meetings of the partners are not provided for except by inference, no mention is made of a common seal and no provision is made for limiting the liability of the members. It differs from an ordinary partnership in that it is not dissolved by the death of one or more of the partners, but re-

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[14] C. B. I-1, page 3; A. R. R. 789.

[15] **[Former Procedure]** All limited partnerships were formerly considered corporations. (Reg. 33, 1918, Art. 62.)

sembles a partnership and differs from a joint stock association or corporation in that it does not provide for the free transferability of the interest of a member.

It is held, therefore, that the M Company is a partnership and should be required to file returns as such. (C. B. 3, page 15; O. D. 599.)

Types classed as corporations.—The regulations are frank in stating that when there is a doubt it will be resolved in favor of corporate status. As the natural presumption would be just the opposite, i.e., that a limited partnership is a partnership unless clearly shown to possess all the qualities of a corporation, the correctness of the regulation may be questioned.

Regulation. On the other hand, limited partnerships of the type of partnerships with limited liability or partnership associations authorized by the statutes of Pennsylvania and of a few other States are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members, providing for the transferability of partnership shares, and capable of holding real estate and bringing suit in the common name, are more truly corporations than partnerships and must make returns of income and pay the tax as corporations. The income received by the members out of the earnings of such limited partnerships will be treated in their personal returns in the same manner as distributions on the stock of corporations. In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized. A Michigan partnership association is a corporation. Such a corporation may or may not be a personal service corporation. . . . . (Art. 1506.)

Ohio partnerships.—

Ruling. A partnership association or limited partnership organized under sections 8059-8078 of the Ohio Code is an association and not a partnership, within the meaning of section 1 of the Revenue Act of 1918, and is taxable as a corporation. (C. B. 2, page 11; O. D. 444.)

Virginia partnerships.—

Ruling. Virginia partnership associations or limited partnerships formed under sections 2878 to 2886, inclusive, of the Virginia code of 1904, are to be treated as corporations or joint-stock companies for income tax purposes.

The status of Virginia limited partnerships formed under the act of March 14, 1918 (acts of Assembly of Virginia, 1918), must be determined in each case by consideration of the certificate of partnership and all pertinent facts. (C. B. 1, page 9; O. D. 334.)

"Pennsylvania" type of limited partnerships.—Limited partnerships of the type referred to in article 1506 are those organized under the act of July 9, 1901,[16] as amended by the act of April 12, 1917.[17] Such partnerships have no general partners and cannot therefore claim to be partnerships for the purpose of income taxation.

Partnerships organized under The Uniform Limited Partnership Act of April 12, 1917[18] have both general and limited partners and therefore do not come within the scope of article 1506.

Under the circumstances, it would be better to designate such partnerships which are taxed as corporations as being of the "corporation type" rather than of the "Pennsylvania type."

Partnerships composed of corporations.—As a general rule, a corporation cannot legally enter into a partnership.[19] In a few places, as in Hawaii,[20] this rule has been changed by statute. The reason for the general rule is that to allow a corporation to enter into partnership would be contrary to the general theory of the incorporation acts.[21] For income tax purposes, however, it has been held that a partnership composed of corporations organized under the law of Hawaii should be classed as a partnership rather than as a corporation.[22] The subject is not of enough general interest to warrant a full discussion in these pages.

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[16] P. L. 625; 3 Purdon's Digest 3464.
[17] P. L. 38; Laws of Pennsylvania, 1917, page 67.
[18] P. L. 37; Laws of Pennsylvania, 1917, page 55.
[19] 20 R. C. L. 817. See also C. B. 5, page 16; A. R. M. 139.
[20] Revised Laws of Hawaii, 1905, section 2631.
[21] C. B. 3, page 18; Sol. Op. 36.
[22] *Haiku Sugar Co. et al. v. Johnstone*, 249 Fed. 103, 161 C. C. A. 155.

Corporations under the Revenue Act

"Corporation" defined.—The law[23] merely states that the term "corporation" shall include "associations, joint-stock companies and insurance companies."

The regulations define joint-stock companies and associations as follows:

REGULATION. Associations and joint-stock companies include associations, common-law trusts, and organizations by whatever name known, which act or do business in an organized capacity, whether created under and pursuant to State laws, agreements, declarations of trust, or otherwise, the net income of which, if any, is distributed or distributable among the members or shareholders on the basis of the capital stock which each holds or, where there is no capital stock, on the basis of the proportionate share or capital which each has or has invested in the business or property of the organization. A corporation which has ceased to exist in contemplation of law but continues its business in corporate form is an association or corporation within the meaning of section 2, but if it continues its business in the form of a trust, it becomes subject to the provisions of section 219. (Art. 1502.)

"Domestic corporation" defined.—The test of a domestic corporation, for the purpose of the Revenue Act, is the same as that applied to partnerships; that is, it must be organized in the United States, which include only the states, the District of Columbia, and the territories of Alaska and Hawaii. Corporations created outside these limits are foreign corporations.[24]

The Treasury has held, however, that a corporation receiving a charter from the United States Court for China, and holding itself out to be a corporation under the laws of the United States, will, for tax purposes, be considered a domestic corporation.[25] Corporations organized under the China Trade Act, 1922, are considered as domestic corporations for income tax purposes (see Chapter XV).

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[23] Section 2.
[24] Section 2 (4).
[25] C. B. 3, page 19; O. D. 661.

Corporations distinguished from other types of organizations.—The Treasury has differentiated certain types of organizations.

Syndicates and joint adventures.—The ordinary syndicates and joint adventures are held not to be associations.[26] But a syndicate where "a shareholder's certificate entitles him to share in the distribution of profits during the life of the enterprise, to share in the distribution of assets upon dissolution, and to vote on questions affecting the management and control of the business," was held to be an association.[27]

Mining partnerships.—Mining "partnerships" in Colorado and Idaho have been held to be associations because the shares are transferable and because such an organization "in all its essential elements is precisely like a corporation."[28]

Trusts and associations.—The courts[29] have differentiated a trust from an association, holding that:

An organization, in form a trust, created by an agreement of the stockholders of several street railway corporations desiring to effect a unitary control of the properties of such corporations, is an association within Section II, Paragraph G (a), of the Act, where the agreement uses language that reads much like the state corporation law, and superimposes that organization upon the several corporations by placing the legal title to the capital stock of those corporations in the trustees named, who are to do certain specified things only, and by providing for a committee which controls even the power of the trustees to vote the capital stock of the corporations, and which is elected and controlled by what are called participating shareholders, who hold certificates of common and preferred participating shares issued by the trustees in lieu of the capital stocks of the corporations.

An association may be organized independently of any statute, and when so organized is nevertheless subject to income tax as such.

This case was decided under the 1913 law, but the same principle will apply under all later statutes.

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[26] Reg. 45, Art. 1507.

[27] C. B. 4, page 9; O. D. 896.

[28] C. B. 5, page 9; A. R. R. 652.

[29] *Chicago Title & Trust Company as Trustee v. Smietanka, Collector*, 275 Fed. 60; the text is a quotation from a digest of the case appearing in T. D. 3193.

ASSOCIATION DISTINGUISHED FROM PARTNERSHIP.—

REGULATION. An organization the membership interests in which are transferable without the consent of all the members, however the transfer may be otherwise restricted, and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such, is an association and not a partnership. A partnership bank conducted like a corporation and so organized that the interests of its members may be transferred without the consent of the other members is a joint-stock company or association within the meaning of the statute. A partnership bank the interests of whose members can not be so transferred is a partnership. (Art. 1503.)

A bank which had issued certificates of ownership was held not to be an association but a partnership. Certificates could not be transferred without the consent of the other members, and each member was liable for all debts.[30]

A private banking institution, unincorporated, where the interests were transferable without the consent of the other members, was held to be an association.[31]

MASSACHUSETTS TRUSTS.—Massachusetts trusts have grown up in part because, until about ten years ago, it was not possible to organize a corporation under the Massachusetts law to own and operate real estate. Out of the common practice of putting real estate in the hands of trustees for legal ownership and management, with certificates issued to the beneficiaries, grew the practice of carrying on other lines of business with the same trust organization in cases where it was considered that a trust was preferable to a corporation. Hence, in practice, there are all kinds of Massachusetts trusts. In some the beneficiaries have little or no control over the management of the trust; others have practically all the characteristics of corporations (except the actual corporate existence and the limited liability of a stockholder in a corporation), and are governed by elaborate by-laws providing for annual meetings of certificate holders, and for the election of

[30] C. B. 5, page 9; O. D. 1083.
[31] C. B. I-1, page 1; I. T. 1150.

trustees for relatively short periods of time, thus vesting a large measure of control in certificate holders.

From a tax standpoint the question is: Is a Massachusetts trust an ordinary trust or an association? If the latter, it is taxable as a corporation; if the former, the income, if distributable, is taxable to the beneficiaries.

In the case of *Crocker v. Malley,*[32] the court pointed out that, by the terms of the trust, the beneficiaries were "trust beneficiaries only, without partnership, association or other relation whatever *inter sese*." It also pointed out that the trustees had discretion to distribute income or to add it to capital, although in fact they did make complete distribution, and that the beneficiaries had no control over the management of the trust, except that their assent was necessary to any increase of the trustees' compensation, to the filling of vacancies among the trustees and to the modification of the terms of the trust. In this case also, it was held that the purpose of the trust was not to run a business, but to hold certain shares of stock and property for a limited period of years, preparatory to liquidation of the trust property. Upon these facts the court found that the trust did not have the attributes of an association, and that the provisions of the Income Tax Act of October 3, 1913, section II, G (a), did not require that such a trust be treated as a corporation for the purpose of taxation. The opinion in the case does not deal directly with the question whether the trust, as a trust, or the beneficiaries are accountable for a tax on the dividends received by the trust, because under the withholding provisions of the 1913 act, the trustees were liable to make a payment of tax in any event, whether they were taxable themselves or merely paid on behalf of the beneficiaries.

The test laid down by the Treasury is whether the beneficiaries have a voice in the business.

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[32] 249 U. S. 223, 63 L. Ed. 573, 39 Sup. Ct. 270, 2 A. L. R. 1001. See also *Malley v. Howard et al* (June 6, 1922), 281 Fed. 363.

RULING. Where beneficiaries holding certificates evidencing their interest under a so-called "Massachusetts trust" agreement annually elect persons delegated to conduct the affairs of the trusts, thus retaining a voice in the business, the trust is an association and is subject to the normal tax upon its income under the Acts of 1913, 1916, and 1918; the excess profits tax under the Acts of 1917 and 1918; the capital stock tax under the Acts of 1916 and 1918; and the certificates issued by the trust to the beneficiaries are subject to the stamp tax under the Acts of 1917 and 1918.

Where the trustees originally appointed were to hold office during the entire period of the trust, the right of the shareholders being limited to filling vacancies, the beneficiaries not retaining any substantial control over the affairs of the trust, such a trust is not an association or taxable as such under section 230 of the Act of 1918, but under section 219 relating to trusts. They are not subject to the excess profits tax nor the capital stock tax, nor are the certificates issued by the trustees subject to stamp tax. (C. B. 1, page 5; S. 1068.)

The question whether beneficiaries in such trusts must return their distributive shares of income of the trust, or merely the income which is distributed to them, answers itself in accordance with the general rules applicable to corporations and trusts. Clearly, if the trust is of such a nature that it must be taxed as a corporation, its distributions are dividends and its shareholders have no taxable interest in its undistributed earnings. On the other hand, if the trust upon its peculiar facts is classifiable for tax purposes as a trust and not as a corporation, the question whether the beneficiaries must return their distributive shares of income, or only the income distributed to them, depends upon their rights under the trust to have income distributed. In the *Crocker* case the trustees had discretion to distribute income or to add it to capital. According to the Treasury,[33] in such a case all the income would be taxed to the trustees. It would seem, however, that the language in section 219 (a-3) and (c), which makes income taxable to the trustees if "held for future distribution under the terms of the will or trust," looks to the act of the trustee under his authority given by the trust instrument as

[33] C. B. 1, page 176; S. 1088. See also Art. 342.

determining whether or not the income, under the language of the statute, is "held for future distribution."

LIMITED PARTNERSHIPS.—Certain types of limited partnerships are taxed as corporations. See pages 38, 39.

"Personal Service Corporations" under the Revenue Act

In order to relieve certain types of corporations from the excess profits tax, a special class of "personal service corporations" was established and defined as follows:

LAW. Section 200. . . . . (5) The term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits, or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

Corporations falling within this class were treated as partnerships, the stockholders being taxed on their distributive shares and the corporations as such being relieved of all taxes.

The personal service corporation, being essentially a creature of the excess profits tax, disappeared with the repeal of that tax as of December 31, 1921.

The intention of Congress has not been carried out by the Treasury. As a result many corporations of the personal service type have been denied their proper classification. Relief under sections 327 and 328 of the 1918 law has been extended to them, but this is a poor substitute. In the opinion of the author the law has not been correctly interpreted. Until the United States Supreme Court broadly interprets the law, taxpayers should protect their rights. The only new decision of interest during 1922[34] is distinctly in favor of the ordinary

[34] [Former Procedure] The United States District Court for the Southern District of New York, in a decision handed down March 10,

personal service corporation. Those who are interested in the procedure which governed these corporations during the time the law was supposed to be in force are referred to *Income Tax Procedure,* 1922, pages 813-841.

1922, in the case of *Martin, Inc., v. Edwards* (not yet reported; see C. B. I-1, page 8; Ct. D. 25), held "that the plaintiff had more than a nominal capital and had a substantial invested capital which was employed in making advances to or on account of the mines, and also in buying merchandise on its own account for profitable sale." The plaintiff's income from profits from buying and selling and from interest were greater than its commission from selling for account of others. The court made this significant remark: "If it had limited itself to buying and selling on commission, with a small incidental trading on its own account, the plaintiff's contention would be good."

CHAPTER III

EXEMPT INCOME IN GENERAL, AND EXEMPT CORPORATIONS

Exemptions under the income tax are granted for constitutional reasons, in order to avoid double taxation, for reasons of public welfare, to assist certain kinds of enterprises, or to encourage certain forms of investment.

Exempt Income in General

Exempt income may be conveniently divided into four classes:

1. Income which is exempt from all taxes imposed by the 1921 revenue act because it is received by certain types of corporations or by states or by the political subdivisions thereof. This class of exemptions is dealt with in this chapter.
2. Income which is exempt because, geographically, it lies beyond the scope and application of the law. (See Chapter XV.)
3. Income such as is not included in either of the above classes, which is exempt from both normal tax and surtaxes. Such items are not included in gross income. (See Chapter XV.)
4. Income such as is not included in any of the above classes, which is exempt from normal tax but is subject to surtax. (See Chapter XV.)

The first class can be called an "exemption of the person," while the other three are "exemptions of the income."

No individual[1] is entirely exempt from the tax merely be-

[1] This statement includes minors. See Chapter V

cause of his status or character as an individual unless one construes the personal exemption as an exception to this statement. That exemption, of course, operates to relieve entirely from taxation the person whose income is smaller than the specified amounts.

If one should receive all his income from interest upon the obligations of a state or of a political subdivision thereof, or upon certain of the obligations of the United States or its possessions or from securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916, he would be subject to no income tax and would not be required to make any return, however large that income might be. He might receive and enjoy his income as if the tax did not exist. This is true even though, in addition, he receives taxable income of any amount less than $1,000 (single person) during the year. If he receives more than $1,000 of such additional taxable income, he proceeds in the same manner as any other taxpayer.

Taxpayers who receive dividends from the stock of American corporations subject to the income tax, or who receive interest on certain government securities, are exempt from the normal taxes on such income but are nevertheless required to report such items annually if their total net income is large enough to justify them in making any return at all, or if their gross income exceeds $5,000.

Exempt Corporations

Certain corporations are expressly exempt from the provisions of the law.[2]

Types of corporations exempt.—The law groups the corporations which are expressly exempt under fourteen heads:

[2] In *Commercial Health & Accident Co. v. Pickering, Collector* (281 Fed. 539, January 3, 1922), the court held that the principle of construing taxing acts in favor of the taxpayer and against the government, does not apply to a claim for exemption from taxation. In such a case the excepting section must be strictly construed.

Law. Section 231. That the following organizations shall be exempt from taxation under this title— . . . .

Labor, agricultural or horticultural organizations.—

Law. Section 231. . . . . (1) Labor, agricultural, or horticultural organizations; . . . .

Regulation. Agricultural or horticultural organizations exempt from tax do not include corporations engaged in growing agricultural or horticultural products or raising live stock or similar products for profit, but include only those organizations which, having no net income inuring to the benefit of their members, are educational or instructive in character and have for their purpose the betterment of the conditions of those engaged in these pursuits, the improvement of the grade of their products, and the encouragement and promotion of these industries to a higher degree of efficiency. Included in this class as exempt are organizations such as county fairs and like associations of a quasi-public character, which through a system of awards, prizes, or premiums are designed to encourage the production of better live stock, better agricultural and horticultural products, and whose income, derived from gate receipts, entry fees, donations, etc., is used exclusively to meet the necessary expenses of upkeep and operation. Societies or associations which have for their purpose the holding of annual or periodical race meets, from which profits inure or may inure to the benefit of the members or stockholders, do not come within the terms of this exemption. A corporation engaged in the business of raising stock or poultry, or growing grain, fruits, or other products of this character, as a means of livelihood and for the purpose of gain, is an agricultural or horticultural society only in the sense that its name indicates the kind of business in which it is engaged, and it is not exempt from tax. (Art. 512.)

It has been specifically held that "a business activity organized for the purpose of affording employment to the members of a certain labor union, ... not a part of the union as such, although . . . . owned and controlled by the union," . . . . paying wages to the members employed, and turning all profits, after paying expenses, into the treasury of the union, is not exempt.[3]

Mutual savings banks.—

Law. Section 231. . . . . (2) Mutual savings banks not having a capital stock represented by shares; . . . .

[3] C. B. 2, page 211; O. D. 523.

Regulation. A Massachusetts savings bank, otherwise exempt, which establishes an insurance department under the statutes of that State, does not thereby become subject to tax upon the income received by such department. (Art. 513.)

Ruling. A savings bank within the accepted meaning of the term contemplates the ordinary institution of that kind as organized and conducted in accordance with the statutes of the various States. Its manner of investing the savings of depositors is restricted. Furthermore, the funds are received by deposits ordinarily made, rather than by a contract under which there arises a binding duty to make future deposits. Therefore an organization which receives deposits from its members by contract under which there arises a binding duty to make future deposits, and which is operated for the purpose of speculation rather than for savings, is not a mutual savings bank within the meaning of section 231 (2) of the Revenue Act of 1918. (C. B. 4, page 262; O. D. 780.)

Fraternal beneficiary societies.—

Law. Section 231. . . . . **(3) Fraternal beneficiary societies, orders, or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system; and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents; . . . .**

Regulation. A fraternal beneficiary society is exempt from tax only if operated under the "lodge system," or for the exclusive benefit of the members of a society so operating. "Operating under the lodge system" means carrying on its activities under a form of organization that comprises local branches, chartered by a parent organization and largely self-governing, called lodges, chapters, or the like. In order to be exempt it is also necessary that the society have an established system for the payment to its members or their dependents of life, sick, accident, or other benefits. (Art. 514.)

The following ruling indicates the narrow interpretation which the Treasury places upon the law.[4]

Ruling. A fraternal beneficiary society is a society whose members have adopted the same or a very similar calling, avocation or profession, or who are working in unison to accomplish some worthy object and who for that reason have bound themselves together as an association or society to aid and assist one another and to promote the common cause. The term "fraternal" can properly be applied to such an association for the reason that the pursuit of

[4] See also C. B. 2, page 207; O. D. 508.

a common object usually has a tendency to create a brotherly feeling among those who are thus engaged. The absence of profit in the operation of such an association is not the test as to whether it is within the exemption as a fraternal beneficiary society, but the want of a fraternal side or object which it is in some manner organized to promote. A fraternal beneficiary society may be a mutual insurance company, but must be something more; it must be primarily fraternal and also, in order to fall within the exemption provided for by section 231 (3) of the Revenue Act of 1918 must be operated under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system. (See *Commercial Travellers Life and Accident Association v. Rodway*, 235 Fed. 370.) (C. B. 3, page 236; Digest O. D. 690.)

BUILDING AND LOAN ASSOCIATIONS.—

LAW. Section 231. . . . . (4) **Domestic building and loan associations substantially all the business of which is confined to making loans to members; and cooperative banks without capital stock organized and operated for mutual purposes and without profit; . . . .**

The principal tests applied to a building and loan association to determine its right to exemption, are whether the members share in the profits on practically the same footing and that substantially all its business is confined to making loans to members.[5]

REGULATION. In general, a building and loan association entitled to exemption is one organized pursuant to the laws of any State, Territory, or the District of Columbia, which accumulates funds to be loaned primarily to its shareholders for the purpose of building or acquiring homes. In order to be exempt the association (1) must be mutual, that is, all of its stockholders or members must share in the profits on substantially the same footing; and (2) must be operated so that substantially all of its business is confined to the making of loans to bona fide shareholders. A building and loan association otherwise exempt does not lose its exempt status because—

(1) It has paid-up shares which are (*a*) preferred as to earnings, and (*b*) have a definite rate of interest which may be higher than the rate of dividends paid on other stock.

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[5] **[Former Procedure]** The phrase included in the 1921 law specifically applying this second test to building and loan associations did not appear in the 1918 law.

Under the 1909 law, it was held that making loans to and receiving deposits from non-members did not render building and loan companies taxable (*Central Building Loan & Savings Co. v. Bowland; Bellefontaine Bldg. & Loan Co. v. McMaken*, 216 Fed. 526).

(2) It borrows money (accepting deposits is held to be a form of borrowing) which it uses for loans to shareholders, the dues, fines, and penalties paid by shareholders being inadequate for this purpose.

(3) It makes loans to nonmembers from accumulated funds which are not needed for loans to shareholders. In any such case, however, the burden will be upon the association to show that substantially all of its loans are made to members.

(4) The amount of its prepaid or full-paid stock is disproportionate to running or installment stock, provided the issuance of such prepaid or full-paid stock is ancillary to the furtherance of the main business of the association; that is, that it is intended to provide a fund from which loans may be made primarily to persons subscribing to running or installment stock to enable them to acquire or build homes.

Cooperative banks without capital stock organized and operated for mutual purposes and without profit are exempt. Credit unions such as those organized under the laws of Massachusetts, being in substance and in fact the same as cooperative banks, are likewise exempt from tax. (Art. 515.)

The Treasury has been upheld in the courts recently[6] in its interpretation of the building and loan association exemption. The undisputed facts showed that in the case of this association, operating under sections 9648 and 9657 of the General Code of Ohio, "about 80 per cent of its receipts and 97 per cent of its loans" were transactions with non-members. The court held that "mutuality of interest between stockholders, on the one hand, and depositors and borrowers, on the other," was lacking, and that "the business conducted was in the main not that of a building association as ordinarily conceived."

The following ruling has been published interpreting the 1918 law.

Ruling. Where a large proportion of the loans of an association are made upon such securities as stocks, automobile notes and personal endorsements and only a small proportion upon real estate, it is held that such an association is not a domestic building and loan association within the meaning of section 231 (4) of the Revenue

[6] *Lilley Building and Loan Company v. Newton M. Miller, Collector*, 280 Fed. 143. (C. B. I-1, page 253; Ct. D. 27.)

Act of 1918, and must file returns of annual net income and pay any tax shown to be due thereon. (C. B. 5, page 201; O. D. 1088.)[7]

CERTAIN CEMETERY COMPANIES.—

LAW. Section 231. . . . . (5) **Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private stockholder or individual; . . . .**

REGULATION. A cemetery company in order to be exempt must be owned and operated exclusively for the benefit of its lot owners or must not be operated for profit. Any cemetery corporation chartered solely for burial purposes and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private stockholder or individual, is exempt from income tax. A cemetery company of which all lot owners are members, issuing preferred stock entitling the holder to a semiannual dividend of 4 per cent, and whose articles of incorporation provide that the preferred stock shall be retired at par as soon as sufficient funds are realized from sales and that all funds realized in addition thereto shall be used by the company for the care and improvement of the cemetery property, is within the exemption. (Art. 516.)

The wording of this regulation gives effect to the additional requirement of the 1921 law, that profits shall not inure to the benefit of private stockholders or individuals.[8]

RELIGIOUS, CHARITABLE, EDUCATIONAL, ETC., SOCIETIES.—

LAW. Section 231. . . . . (6) **Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals,[9] no part of the net earnings of which inures to the benefit of any private stockholder or individual; . . . .**

REGULATION. This exemption applies to corporations, associations, and community chests, funds, or foundations. In order to be exempt,

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[7] Also see these rulings: C. B. 4, page 262; O. D. 768 and C. B. 5, page 201; O. D. 1129.

[8] A ruling under the 1918 law stated that the cemetery "must be owned and operated exclusively for the benefit of *all* lot owners." (C. B. 5, page 201; Sol. Op. 120).

[9] **[Former Procedure]** The societies for the prevention of cruelty to children or animals were included for the first time in the 1918 law.

the organization must meet three tests: (*a*) it must be organized and operated for one or more of the specified purposes; (*b*) it must be organized and operated exclusively for such purposes; and (*c*) no part of its net income must inure to the benefit of private stockholders or individuals.

(1) Charitable corporations include an association for the relief of the families of clergymen, even though the latter make a contribution to the fund established for this purpose; or for furnishing the services of trained nurses to persons unable to pay for them; or for aiding the general body of litigants by improving the efficient administration of justice. Educational corporations may include an association whose sole purpose is the instruction of the public. This is true of an association to promote acquaintance with the Spanish language and literature, although it has incidental amusement features; of an association to increase knowledge of the civilization of another country; and of a Chautauqua association whose primary purpose is to give lectures on subjects useful to the individual and beneficial to the community and whose amusement features are incidental to this purpose. But associations formed to disseminate controversial or partisan propaganda are not educational within the meaning of the statute. Scientific corporations include an association for the scientific study of law, to the end of improvement in its administration.

(2) Where a religious corporation owns a large quantity of farm land and works it, and also manufactures and sells clothing and other articles for profit, it is not operated exclusively for religious purposes and is not exempt, even though its property is held in common and its profits do not inure to the benefit of individual members of the society.

(3) It does not prevent exemption that private individuals, for whose benefit a charity is organized, receive the income of the corporation or association. The statute refers to individuals having a personal and private interest in the activities of the corporation, such as stockholders. If, however, a corporation issues "voting shares," which entitle the holders upon the dissolution of the corporation to receive the proceeds of its property, including accumulated income, the right to exemption does not exist, even though the by-laws provide that the shareholders shall not receive any dividend or other return upon their shares. (Art. 517.)

This article now includes community chests, funds, or foundations, and literary societies. Orchestral societies and trusts, the income of which is used for religious purposes, are no longer specifically excluded.

An association formed to manage and control "a band of musicians for the purpose of giving free public concerts," etc.,

held to be exempt on the ground that "Music is recognized as one of the liberal arts and sciences. . . . . The fostering of an appreciation of or desire for good music and the promotion of musical art are activities of an educational nature." (I-42-554; I. T. 1475.)

A hospital association organized to furnish medical and surgical aid and care to employees of corporations, persons, or partnerships with whom contracts are made and which does not treat any patients free, is not a charitable organization within the meaning of section 231 (6) of the Revenue Act of 1918, and will be required to file returns of annual net income.[10]

A memorial fund of which the M Corporation is trustee is controlled by a board of directors. It is organized not to engage in a charitable undertaking itself, but to distribute its income to charitable institutions and to worthy individuals. Held, it is not a charitable corporation or association within the provisions of section 11 (a), sixth, of the Revenue Act of 1916 as amended, or section 231 (6) of the Revenue Act of 1918. Contributions made to such a fund are not deductible under section 5 (a), ninth, of the Revenue Act of 1916 as amended, or section 214 (a-11) of the Revenue Act of 1918.[11]

A private educational corporation issues no stock and i: managed by a board of trustees. It derives its income fron tuition fees paid by students. After payment of expenses the balance is placed in an operating fund to meet operating expenses in the future. If this operating fund exceeds the current year's income, any amount in excess of 25 per cen is placed in a students' loan fund, from which deserving st dents may borrow money for the purpose of pursuing a cours of study in the school. No part of the earnings of the schoo inures to the benefit of any individual or individuals connecte with the corporation in any manner whatever, and the by-la

[10] C. B. 5, page 203; O. D. 993.
[11] C. B. 4, page 264; O. D. 872.

provide that no remunerations of any kind shall be paid to the board of trustees for their services as such. The corporation was held to be exempt from taxation under the provisions of section 231 (6).[12]

A corporation organized for the purpose of conducting a military school for profit, the stock being entirely owned by the officers, directors, and teachers of the institution, is not exempt from income tax. The term "private" is not used in the statute in contradistinction to "official," whether the latter be used in a military or institutional sense, but as an antonym of "public," the supposed beneficiary of the benevolent activities of an institution devoted exclusively to public betterment; private pecuniary profit is the test to be applied.[13]

A publishing corporation, primarily religious in character, but not exclusively so, does not come within the exemption.[14]

An incorporated pension organization of a corporation whose fund consists in part of compulsory contributions of the salaries of the members and out of which payments of annuities are made to its members on account of incapacity, or to their widows or dependents in the event of death, is not a charitable organization and is therefore not exempt from taxation under the provisions of section 231 of the Revenue Act of 1918. (C. B. 4, page 264; Digest A. R. R. 477.)

A lyceum and Chautauqua association which receives its income from admission to its entertainments and which uses its income, first, to defray the expenses of operating, second, to pay for its assets purchased, and third, to build up a surplus, is held to be engaged in an ordinary business enterprise, and is not exempt under any of the provisions of section 231 of the Revenue Act of 1918.[15]

A league which is organized to bring about a fair and open-minded consideration of social, industrial, political, and

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[12] C. B. 5, page 204; O. D. 1102.
[13] C. B. 4, page 266; T. D. 3164.
[14] C. B. 5, page 204; O. D. 1142.
[15] C. B. 5, page 203; O. D. 1077.

international questions among college students, the income of which is derived from private subscriptions, no part of which inures to surplus or the benefit of any stockholders or individuals, is held to be exempt within the meaning of section 231 (6) of the Revenue Act of 1921.[16]

CHAMBERS OF COMMERCE, ETC.—

LAW. Section 231. . . . . (7) **Business leagues, chambers of commerce, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private stockholder or individual; . . . .**

REGULATION. A business league is an association of persons having some common business interest, which limits its activities to work for such common interest and does not engage in a regular business of a kind ordinarily carried on for profit. Its work need not be similar to that of a chamber of commerce or board of trade. The fact that it engages in a regular business of a kind ordinarily carried on for profit but on a cooperative basis or so as to produce only sufficient income to be self-sustaining, is not ground for exemption. An association engaged in furnishing information to prospective investors, to enable them to make sound investments, is not such a league, since its members have no common business interest, and it is not exempt, even though all of its income is devoted to the purpose stated. A clearing house association, not organized for profit, no part of the net income of which inures to any private stockholder or individual, is exempt provided its activities are limited to the exchange of checks and similar work for the common benefit of its members. An association of persons who are engaged in the business of carrying freight and passengers by boats propelled by steam, which is designed to promote the legitimate objects of such business, and all of the income of which is derived from membership dues and is expended for office expenses and the salary of a secretary-treasurer, is exempt from tax. An incorporated cotton exchange whose shares carry the right to dividends is organized for profit and is not exempt. (Art. 518.)[17]

An association which held patents for and issued licenses to its members, which charged fees for the use of patents, which acted as a receiver or trustee for insolvent members, was held not to be a business league even though it issued no

[16] C. B. I-1, page 256; I. T. 1224.

[17] The third sentence of this regulation appeared in substance in a 1921 ruling. (C. B. 4, page 269; O. D. 786.)

stock, paid no dividends, and no part of its net income inured to any of its members.[18]

Civic leagues.—

Law. Section 231. . . . . **(8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare; . . . .**

Regulation. A corporation having capital stock and possessing a charter which authorizes it to buy, improve, and sell real estate is organized for profit within the meaning of the statute and is not exempt from tax as a civic league or organization, even though it no longer exercises such powers for profit and is operated exclusively for the promotion of social welfare. (Art. 519.)

Social clubs.—

Law. Section 231. . . . . **(9) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private stockholder or member; . . . .**

Regulation. The exemption applies to practically all social and recreation clubs which are supported by membership fees, dues, and assessments. If a club, by reason of the comprehensive powers granted in its charter, engages in traffic, in agriculture or horticulture, or in the sale of real estate, timber, etc., for profit, such club is not organized and operated exclusively for pleasure, recreation, or social purposes, and any profit realized from such activities is subject to tax. (Art. 520.)

Rulings. A provision in the by-laws of a country club, that, in the event of the dissolution of the club, the holder of a life membership shall participate in the distribution of the assets of the club after its other debts are paid and before any sums are paid to either regular members or shareholders, is not alone sufficient to make the club liable to render income tax returns. . . . . (C. B. 1, page 202; S. 958.)

A club formed for the purpose of providing for the members thereof a suitable meeting place, a library, and a dining room, where meals will be furnished to the members, the income being derived from membership dues and the receipts for food, wine, and cigars purchased by members, and no part of the net earnings inuring to the private benefit of any member, is entitled to exemption from taxation and will not be required to file returns of annual net income. (C. B. 1, page 203; O. D. 108.)[19]

[18] I-33-458; A. R. R. 1072.
[19] See also I-34-468; I. T. 1427.

Mutual insurance companies, etc.—See Chapter XLIII.

Co-operative associations, etc.—

Law. Section 231. . . . . (11) **Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them; or organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such supplies and equipment to such members at actual cost, plus necessary expenses;** . . . . [20]

Regulation. (*a*) Cooperative associations, acting as sales agents for farmers, fruit growers, dairymen, etc., and turning back to them the proceeds of the sales, less the necessary selling expenses, on the basis of the produce furnished by them, are exempt from income tax. Thus cooperative dairy companies, which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among their members upon the basis of the quantity of milk or of butter fat in the milk furnished by such members, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, or if the association deducts more than necessary selling expenses, it does not meet the requirements of the statute and is not exempt. The maintenance of a reasonable reserve for depreciation or possible losses or a reserve required by State statute will not necessarily destroy the exemption. A corporation organized to act as a sales agent for farmers and having a capital stock on which it pays a fixed dividend amounting to the legal rate of interest, all of the capital stock being owned by such farmers, will not for that reason be denied exemption.

(*b*) Cooperative associations organized and operated as purchasing agents for farmers, fruit growers, dairymen, etc., for the purpose of buying supplies and equipment for the use of members and turning over such supplies and equipment to members at actual cost, plus necessary expenses, are also exempt. In order to be exempt under either (*a*) or (*b*) an association must establish that it has no net income for its own account. An association acting both as a sales and a purchasing agent is exempt if as to each of its functions it meets the requirements of the statute. (Art. 522.)

This article permits a sales organization to be incorporated

[20] **[Former Procedure]** The second half of this subsection was first introduced in the 1921 law.

and to pay a fixed dividend on its capital stock without forfeiting its right to exemption.

Rulings. An incorporated fruit growers' union which conducts its business at a profit, thereby accumulating a fund out of which dividends are paid, is deprived of exemption from tax if it allows persons who are not fruit growers to acquire stock and thus share in the profits. To the extent that it has such stockholders it loses its character as sales agent acting for the mutual benefit of the fruit growers, and accordingly its exemption from tax also. The union may, however, deduct from gross income amounts periodically returned to members as a refund of profits on business transacted with them, and proportioned to the amount of such business. (C. B. 1, page 208; O. D. 64.) [See also I-46-594; I. T. 1499.]

A cooperative store managed by a university for the purpose of selling to its students supplies of every kind, and in case of dissolution its property reverting to the trustees of the school, does not come within the class of corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof. It is actively engaged in the operation of a business in which profits are realized and will, therefore, be required to file returns of annual net income and to pay any tax thereby shown to be due. (C. B. 1, page 208; O. D. 65.)

Before paying tax on an apparent profit from the university store described in the last ruling, the university should make sure that all proper charges, such as rent for quarters furnished the store, etc., are deducted.

Ruling. A cooperative apartment-owning corporation, which derives its income from collecting the expense of operating the apartments each month from its members, each of whom is entitled to occupy an apartment in the building, is not exempt from taxation. (C. B. 5, page 204; Digest O. D. 1042.)

A company whose stock was owned by, and which acted as sales agent for, certain lumber companies, and which made no profit, was held not to be a farmers', fruit growers', "or like association," because lumbering is not like fruit growing.[21] The foregoing would seem to be an extremely narrow construction. The law states that associations, other than farmers and fruit growers, must be "like associations"; it

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[21] C. B. I-1, page 263; I. T. 1312.

does not state that lumbermen must be like fruit growers. If lumbermen or shoemakers organize an association which markets the products of its members or purchases supplies for them, it is a co-operative association and is just as much exempt as if organized by farmers.

CORPORATIONS SERVING EXEMPT CORPORATIONS.—

LAW. Section 231. . . . . (12) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title;[22] . . . .

FEDERAL LAND BANKS.—

LAW. Section 231. . . . . (13) Federal land banks and national farm-loan associations as provided in section 26 of the Act approved July 17, 1916, entitled "An Act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create Government depositaries and financial agents for the United States, and for other purposes"; . . . .

Personal service corporations are listed as subdivision 14 in the 1921 law, with a statement that "this subdivision shall not be in effect after December 31, 1921."[23] See Chapter II.

Establishing a right to exemption.—No corporation is exempt from the tax merely because it is organized and operated not primarily for profit. Unless it comes within one of the fourteen classes enumerated above, it is taxable.

Moreover, not all of the corporations mentioned in the above classes are unconditionally exempt. In some cases a condition is inserted, such as that which states that no part of the net earnings shall inure to the benefit of any private

[22] [Former Procedure] Such corporations were taxable under the 1913 law, T. D. 2137 (January 30, 1915). As to 1909 law, see footnote 28, page 64.

[23] [Former Procedure] As the 14th type of exempt corporation the 1916 law gave the following: "Joint-stock land bank, as to income derived from bonds or debentures of other joint-stock land banks or any federal land bank belonging to such joint-stock land bank."

stockholder. But whether conditionally or unconditionally exempt, the Treasury requires every organization claiming exemption to establish its right to exemption in accordance with the following regulation:

Regulation. In order to establish its exemption, and thus be relieved of the duty of filing returns of income and paying the tax, it is necessary that every organization claiming exemption, except personal service corporations, file an affidavit with the collector of the district in which it is located, showing the character of the organization, the purpose for which it was organized, the sources of its income and its disposition, whether or not any of its income is credited to surplus or may inure to the benefit of any private stockholder or individual, and in general all facts relating to its operations which affect its right to exemption. To such affidavit should be attached a copy of the charter or articles of incorporation and by-laws of the organization. Upon receipt of the affidavit and other papers by the collector, he will inform the organization whether or not it is exempt. If, however, the collector is in doubt as to the taxable status of the organization, he will refer the affidavit and accompanying papers to the Commissioner for decision. When an organization has established its right to exemption, it need not thereafter make a return of income or any further showing with respect to its status under the law, unless it changes the character of its organization or operations or the purpose for which it was originally created. Collectors will keep a list of all exempt corporations, to the end that they may occasionally inquire into their status and ascertain whether or not they are observing the conditions upon which their exemption is predicated. Personal service corporations are not exempt after December 31, 1921; see section 218 of the statute and articles 336-339. (Art. 511.)

It is clear that the Commissioner, not the collector, decides all doubtful cases.

Ruling. An organization which would otherwise be exempt from taxation but which operates in a nonexempt manner is not entitled to exemption under the provisions of section 231 of the Revenue Act of 1918; and furthermore, an organization which is ordinarily exempt but which owns property in excess of its needs and carries on industrial pursuits distinct from its exempt activities is not exempt from taxation. (C. B. 4, page 261; O. D. 953.)

Section 231 is applicable to both foreign and domestic corporations alike, except that foreign building and loan associations and co-operative banks are not exempt. If doubt exists

as to whether a foreign corporation comes within the classes of exempt organizations enumerated, an affidavit showing all the material facts should be presented to the Treasury, in order that the status of the corporation may be determined.

RULING. In dealing with cases coming under section 231, the character of the corporation must be judged by its articles of incorporation, constitution, and by-laws rather than by the declarations of its officers or the method by which it conducts or has conducted its business. Accordingly, if the activities of a company are confined to cooperative selling for the benefit of its patrons, but it is granted additional powers by its charter, it will nevertheless be required to file returns and pay the tax if any is shown to be due. (C. B. 1, page 194; O. D. 190.)

The foregoing ruling may operate to defeat the purpose of the law. The law exempts "organizations" and contains no requirements as to by-laws, etc. An organization which is entitled to exemption on meritorious grounds will get it even though its by-laws are improperly drawn. The following summary of a recent case illustrates the attitude taken by the courts in deciding doubtful questions of this type:[24]

Exemption of a building owned and used by a church for missionary work was contested as not being a "purely public charity" within the meaning of the Pennsylvania constitution. The court sustained the exemption, holding that such a charity was not necessarily one solely controlled by the state as claimed but extended to a private charitable institution not administered for individual gain; that the true test was the character of the objects sought to be attained.

Exempt corporations must withhold taxes and furnish information.—A corporation exempt as to its income is not thereby exempt from "the witholding requirements[25] nor from furnishing information in accordance with the provisions of the Act."[26]

Salaries paid by an exempt corporation are, of course, taxable to the recipient.[27]

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[24] *Board of Home Missions, etc. v. City of Philadelphia,* 109 Atl. 664, 266 Pa. 405.
[25] See Chapter XIV.
[26] See Chapter XIII.
[27] Section 213.

Holding companies exempt on certain dividends received.—The provision of the law which permits corporations to deduct dividends received from certain other corporations [section 234 (a-6)] may operate to exempt the income from this source of the "not doing business" type of holding company.[28] This, of course, is not an express exemption of that type of corporation. Practically, however, it amounts to this in the case of a holding company which receives no income except dividends from certain types of corporations. Nevertheless, even though it has no taxable income, a holding company must make a return.

Income of states from public utilities.—In addition to exempt corporations, there is another "exemption of the person" which should be considered in this chapter. Since the federal government possesses no power to tax income which accrues to states or political subdivisions thereof, the income received by such states from public utilities or from the exercise of governmental functions is not taxable.

LAW. Section 213. That . . . . the term "gross income"— . . . .

(b) Does not include the following items, which shall be exempt from taxation under this title: . . . .

(7) Income derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to the Government of any possession of the United States, or any political subdivision thereof.

Whenever any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, prior to September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility, no tax shall be levied under the provisions of this title upon the income derived from the operation of such public utility, so far as the payment thereof will impose a loss or burden upon such State, Territory, District of Columbia, or political subdivision; but this provision is not intended and shall not be construed to confer upon

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[28] [Former Procedure] Under the 1909 law, most holding companies were held to be exempt (*Butterick Co. v. U. S.*, 240 Fed. 539; appeal dismissed, 248 U. S. 587, 63 L. Ed. 434, 39 Sup. Ct. 5).

such person any financial gain or exemption or to relieve such person from the payment of a tax as provided for in this title upon the part or portion of such income to which such person is entitled under such contract; . . . .

Regulation. Income derived from any public utility or the exercise of any essential governmental function and accruing to any State or Territory of the United States, or to any political subdivision thereof, or to the District of Columbia, or income accruing to the Government of any possession of the United States, or any political subdivision thereof, is exempt from tax. . . . . The income of State workmen's compensation insurance funds established by State statutes is not taxable. In the case of a public utility acquired, constructed, operated, or maintained by a taxpayer under contract with any State, Territory, or political subdivision thereof, or with the District of Columbia, containing an agreement that a portion of the net earnings of such public utility shall be paid to the State, Territory, or political subdivision thereof, or the District of Columbia, the amount so paid may be deducted by the taxpayer as a necessary expense in transacting business. . . . . (Art. 87.)

The intent of the Act, in so far as corporations are concerned, is apparently to permit a corporation, in which a state or local government has a part interest, to deduct the amount of income paid to the state or local government, and to require the tax to be paid only upon the portion which accrues to the corporation or its stockholders or to private persons.[29]

A water company built a plant, which was operated by a municipality, a rental therefor being paid to the water company. Federal income taxes, if assessable, are payable by the city. Held that as the city did not control the company the income taxes are merely additional rental which it must pay.[30]

The fact that a public utility may be under contract with any state, territory, or political subdivision thereof, does not imply that salaries and wages paid to officers and employees of such public utility are exempt from taxation.[31]

[29] See C. B. 1, page 92; O. D. 250.
[30] I-42-551; A. R. R. 1169.
[31] See Chapter XVII.

CHAPTER IV

RETURNS—WHEN AND HOW TO MAKE THEM

The income tax law imposes upon taxpayers the duty of "self-assessment," but Congress empowers the Commissioner of Internal Revenue to require detailed returns so that there may be a check on the taxpayers' methods of computation.

Generally speaking, a "return" may be defined as a statement of taxable net income or of information.

Who shall make returns?—A return shall be made by every individual having a net income of

1. $1,000 or more if single, or if married and not living with husband or wife;[1]
2. $2,000 or more if married and living with husband or wife;
3. $1,000 or more if the head of a family, even though in some cases no tax may be due; and
4. $1,000 or more ($2,000 if married) if a minor and not dependent on the parent.

Also, every individual and every married couple having a *gross* income for the taxable year of $5,000 or over, *regardless of the amount of the net income,* must file a return.[2] These requirements enable the Treasury to scrutinize the deductions by which gross incomes of $5,000 or more are reduced to net incomes so small as to be canceled by the personal exemptions.

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[1] For cases of changes in marital status, see Chapter XV. Fiduciaries must make returns for individuals, trusts or estates for which they act. See Chapter XLII. For returns of non-resident aliens, see Chapter XLI.

[2] **[Former Procedure]** Before 1921, *net* income was the sole basis for individual returns. If there was no taxable net income, no return was required.

Every partnership and corporation[3] (not specifically exempt),[4] whether it has any net income or not, is required to file an annual return. Partnerships as such are not taxable upon any net income so reported, but the returns must nevertheless be made.[5] From January 1, 1922, corporations formerly classed as personal service corporations must make returns as ordinary corporations.

In addition to these statements of total net income received, there are various other returns to be made under the income tax law which give to the Treasury information considered essential to proper administration. The more important of the various types of returns are considered individually later.[6]

Commissioner may require any returns "necessary."—In addition to making specific provisions for certain returns, the law grants to the Commissioner the broad and inclusive power to require any returns which he may consider necessary. The authority is given in the following sections:

LAW. Section 1300. That . . . . every person liable to any tax imposed by this Act, or for the collection thereof, shall keep such records and render, under oath, such statements and returns, and shall comply with such regulations as the Commissioner, with the approval of the Secretary, may from time to time prescribe.

LAW. Section 1307. That whenever in the judgment of the Commissioner necessary he may require any person, by notice served upon him, to make a return or such statements as he deems sufficient to show whether or not such person is liable to tax.

LAW. Section 1303. That the Commissioner, with the approval

[3] For definition of the term "corporation" see page 40.

[4] The law (section 239) states the requirement positively rather than negatively. Exempt corporations must establish their right to exemption. (See Chapter III.)

[5] **[Former Procedure]** Before 1918 no income tax returns were required from partnerships except upon call from the Commissioner. Excess profits tax returns were required under 1917 law.

[6] Detailed illustrations of returns under the 1918 law for individuals appear in the Appendix of *Income Tax Procedure,* 1920; for corporations in the Appendix of *Excess Profits Tax Procedure,* 1921, and in Chapter V of Appendix A of *Income Tax Procedure,* 1922.

Illustrations of returns covering special features under the 1921 law, for individuals, appear in Chapter IX.

of the Secretary, is hereby authorized to make all needful rules and regulations for the enforcement of the provisions of this Act. . . . .

Under the authority thus granted, the Treasury requires various special returns which give details regarding complicated calculations, such as those involved in ascertaining depletion allowances and income from the appreciation of property values.[7]

RULING. Every taxpayer carrying on the business of producing, manufacturing, purchasing or selling any commodities or merchandise, except the business of growing and selling products of the soil, shall for the purpose of determining the amount of income under the Revenue Act of 1921, keep such permanent books of account or records, including inventories, as are necessary to establish the amount of gross income and deductions, credits and other information required by an income tax return. The taxpayer shall produce such books of account or records for the inspection of revenue officers duly authorized by law to inspect the same, at such time and in the manner provided by law. (T. D. 3408, dated November 2, 1922.)

Time for filing returns.[8]—Annual returns from both individuals and corporations[9] are due two months and fifteen days after the close of the taxable year.

LAW. Section 227. **(a) That returns (except in the case of nonresident aliens)**[10] **shall be made on or before the fifteenth day of the third month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made** on or before the 15th day of March. . . . .[11]

"LAST DUE DATE."—

REGULATION. The last due date is the last day upon which a return is required to be filed in accordance with the provisions of the

[7] Form O revised (oil and gas), form D (minerals), form E (coal), form F (non-metals), form T (timber).

[8] For extension of time, see page 69.

[9] For corporations, see section 241 (a).

[10] For special rule applying to non-resident aliens, see Chapter XLI.

[11] **[Former Procedure]** The laws prior to 1918 made March 1 the date for filing returns, except for taxpayers reporting on the basis of fiscal years. In such cases the return was due sixty days after the close of the fiscal year [1913 law, section G (c); 1916 and 1917 laws, section 13 (b)]. To cover the case of individuals who desired to change from a calendar to a fiscal year under the power granted by the 1918 law, the regulations (Art. 441) provided that returns for fiscal years ending during 1918 might be made "on or before the fifteenth day of March, 1919."

statute or the last day of the period covered by an extension of time granted by the collector or Commissioner. When the last due date falls on Sunday or a legal holiday, the last due date for filing returns will be the day following such Sunday or legal holiday. . . . . (Art. 446.)

Filing date in cases of liquidation.—A concern which goes into liquidation may file a return before the expiration of its taxable year or may wait until the end of its taxable year.[12]

Regulation. . . . . A corporation going into liquidation during any taxable year may upon the completion of such liquidation prepare a return covering its income for the fractional part of the year during which it was engaged in business and may immediately file such return with the collector. . . . . (Art. 651.)

Although a liquidating corporation may be a subsidiary of a holding company, the regulations permit the filing of a return immediately after liquidation; but if for the purposes of a consolidated return the holding company desires to withhold the return until the end of its fiscal year, it can do so. The regulation is permissive, not mandatory.

If a return is made for a portion of a taxable year, the exemptions must be reduced.[13] Since this results in a larger tax it is advantageous to wait until the close of the year.

Extensions of time for filing returns.—In the case of both individuals and corporations:

Law. Section 227. (a) . . . . **The Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.**[14] . . . .

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[12] C. B. 3, page 286; O. D. 692.

[13] See Chapter XV as to the $2,000 exemption where income for portion of year is less than $25,000.

[14] **[Former Procedure]** Under the 1913 law (section 3176) the Commissioner was authorized to grant extensions only in case of sickness or absence and even then was limited to thirty days. The 1916 law [section 14 (c)] introduced this provision: "That the Commissioner of Internal Revenue shall have authority, in the case of either corporations

This authorization is, of course, broad enough to permit general extensions as well as extensions in the cases of particular taxpayers. Under section 1311 the local collectors of internal revenue have authority to grant an extension of thirty days only in case of sickness or absence. Power to grant other extensions rests with the Commissioner.[15]

EXTENSION OF TIME FOR JOINT RETURN.—

RULING. Where a husband and wife file a joint return and an extension of time has been granted to either of them, the benefit of the extension inures to both and it will be unnecessary for the other party to secure additional authority. (C. B. 2, page 203; O. D. 521.)

APPLICATION TO THE COLLECTOR FOR THIRTY-DAY EXTENSION IN CASE OF ABSENCE OR SICKNESS.—In case an extension of not more than thirty days is desired because of absence or sickness, application should be made by letter to the local collector with whom the return is to be filed. "In exceptional circumstances" the application may be made directly to the Commissioner.[16]

LAW. Section 1311. [Section 3176, Rev. Stat.] . . . . **If the failure to file a return or list is due to sickness or absence, the collector may allow such further time, not exceeding thirty days, for making and filing the return or list as he deems proper. . . . .**

The conditions which govern extensions of time in cases of individuals and corporations are fully set forth in the following regulation:

REGULATION. It is important that the taxpayer render before the return due date a return as complete and final as it is possible for him to prepare. However, in cases of sickness or absence, collectors are authorized to grant an extension of not exceeding 30 days, where in their judgment such further time is actually required for the making of an accurate return. See article 1002. The application for such extension must be made prior to the due date of the return. The absence or sickness of one or more officers of a corporation at the

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or individuals, to grant a reasonable extension of time, in meritorious cases as he may deem proper." The six months' limitation was first introduced in the 1918 law.

[15] See page 69.

[16] Art. 444.

time the return is required to be filed will not be accepted as a reasonable cause for failure to file the return within the prescribed time, unless it is satisfactorily shown that there were no other principal officers available and sufficiently informed as to the affairs of the corporation to make and verify the return. As a condition of granting an extension of time for filing a return the collector may require the submission of a tentative return and estimate of the tax and the payment of one-fourth of the estimated amount of tax. A tentative return should be made on the usual return form, plainly marked "tentative" at the top, contain a statement as to the estimated amount of tax believed to be due, and be properly executed. No other data need be given. Tentative returns will not be accepted unless permission is obtained previous to filing. A copy of the authority for filing the tenative return must be attached thereto when filed. Where a taxpayer has filed a tentative return and has failed to file a complete return within the period of the extension requested by him, the complete return when filed is subject to penalties prescribed for delinquency. Where a tentative return has been filed and no time has been fixed within which a complete return must be filed, the collector may at any time send notice to the taxpayer to file a complete return within a period of time therein specified by him, and a taxpayer who fails to comply with such request will incur the penalties prescribed by statute for delinquency in filing a return. As to interest see article 1003. Collectors should not grant extensions of time for filing Forms 1096 and 1099.[17] Requests for such extensions should be made to the Commissioner. (Art. 443.)

The regulation as it now stands requires applications to collectors for extensions, in cases of absence or sickness, to be made *prior* to the due date of the returns. The former procedure was to apply for the extension within thirty days *after* the due date of the return. It appears to the author that section 1311 of the law, quoted above, clearly infers that application may be made *after* the expiration of the period in which the return is normally required to be filed; but that the application for such extension must not be delayed beyond the period (thirty days) for which the extension is desired.

Forms 1040-T (individuals) and 1031-T (partnerships) are no longer to be used for tentative returns; the ordinary forms plainly marked "tentative" are to be used. It should

[17] Form 1096—annual return of payments of $1,000 or more. Form 1099—reports of payments of $1,000 or more, which are summarized on form 1096, and are filed with that form.

be noted that a tentative return will not be accepted unless previous permission to file such a return has been given.

Applications to Commissioner for other extensions.—Local collectors are not authorized to grant extensions of more than thirty days or in cases other than those of sickness or absence.[18] The circumstances under which the Commissioner may grant a limited further extension are set forth in the following regulation:

Regulation. If before the end of an extension of thirty days granted by the collector an accurate return can not be made, an appeal for a further extension must be made to the Commissioner with a full recital of the causes for the delay. The Commissioner will not grant an additional extension without a clear showing that a complete return can not be made at the end of the thirty-day period. The Commissioner will grant no such extension beyond the original due date of the third installment of the tax. Either a complete or a tentative return, as complete as possible and giving a ground for assessment of the tax, must be submitted on or before the due date as extended, and the tax shown to be due must be paid with the submission of the return. If a complete return can not be made at that time, the facts must be submitted to the Commissioner for such further action as he deems warranted. In exceptional circumstances the taxpayer may apply originally to the Commissioner for an extension of time. . . . . (Art. 444.)

Extension of time for filing returns due March 15, 1923.[19]—Under the law collectors may grant extensions of

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[18] See page 70.

[19] **[Former Procedure]** Corporations were granted an extension to May 15, 1920, for filing the 1919 returns. (I. T. M. 2420, dated March 4, 1920.)

There was no general extension of time in 1921 but individual extensions were granted in all meritorious cases.

In 1922 the Commissioner granted a general extension to June 15 to domestic corporations with taxable years ending December 31, 1921, and January 31, 1922, and February 28, 1922, conditional upon filing tentative returns accompanied by one-fourth of the estimated tax due on the dates when the returns would otherwise have been filed. (T. D. 3291.) A general extension to May 15 was granted in which to file fiduciary, partnership, and personal service corporation returns, as well as such information returns covering compensation paid to employees as were required in connection with the above returns. (T. D. 3272.) For foreign taxpayers, see page 75, footnote.

Taxpayers who had filed returns before the date of the approval of the 1921 law, November 23, 1921, and who were liable to additional tax under the provisions of that law were called upon to file returns covering such

thirty days in case of sickness or absence. The Commissioner grants extensions up to six months "whenever in his judgment good cause exists." In view of the many and complicated problems involved, it has become increasingly difficult for individuals and corporations to prepare their returns by March 15, even when the law remains unchanged.

There are corporations with ramifications extending the world over which have never before or since the existence of the federal income tax laws been able to close their books within a 75-day period. The Treasury has not dealt harshly with this class of taxpayers, nor with individuals and other corporations upon which a hardship would be worked if extensions were not granted. It does, however, very properly require that when additional time is requested, it shall be asked for in due season and that sound reasons shall be given for the request.

When taxpayers live abroad.—Section 227 (a) of the law provides that the six months' limitation upon the power of the Commissioner to grant extensions of time for filing returns shall not apply to taxpayers who are abroad. On February 11, 1922, a Treasury Decision was issued granting a general extension for the current and for subsequent years to such taxpayers.[20] Instead of filing returns on the fifteenth

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additional tax, and to pay such additional tax at the same time as persons with fiscal years ending February 28, 1922. (T. D. 3305.) The following sentence, included in this Treasury Decision, was eliminated in a later revision (T. D. 3310):

"If no part of the tax for the taxpayer's fiscal year was due until after November 22, 1921, the whole amount of tax due, including the tax due under the original return and the additional tax due under the new return, will be payable in the same installments and at the same times as in the case of payments based on returns for the fiscal year ending February 28, 1922."

[20] **[Former Procedure]** The Treasury issued a general extension to April 15, 1922, in which to file tentative returns, in the case of corporations filing in the District of Hawaii for the calendar year 1921. (C. B. I-1, page 246; I. T. 1257.) Another general extension to May 15, 1922, was granted in the case of individual returns for the calendar year 1921 by persons living or residing in Hawaii and Alaska. The provisions of T. D. 3272, granting an extension until May 15, for filing partnership and fiduciary information returns, were also made to apply to persons in these territories. (C. B. I-1, page 247; T. D. 3306, March 17, 1922.)

day of the third month following the close of the taxable year, they may under the conditions specified file on the fifteenth day of the sixth month. Obviously the limit established in this decision is designed to meet only the ordinary case. The Commissioner has power to make extensions without limit in extraordinary cases of taxpayers abroad.

Ruling. An extension of time for filing returns of income for 1921 and subsequent years and for paying the tax is hereby granted up to and including the 15th day of the sixth month following the close of the taxable year, in the case of (*a*) foreign partnerships and foreign corporations, regardless of whether or not they maintain an office or place of business within the United States; (*b*) domestic corporations which transact their business and keep their records and books of account abroad; (*c*) domestic corporations whose principal income is from sources within the possessions of the United States; and (*d*) American citizens residing or traveling abroad, including persons in military or naval service on duty outside the United States. The installments of tax which are actually due must be paid at the time of filing the return, and the other installments shall be paid as they fall due. In all such cases an affidavit must be attached to the return, stating the cause of the delay in filing. Taxpayers who take advantage of this extension will be charged with interest at the rate of one-half of 1 per cent a month on the first installment of tax from the original due date thereof. (C. B. I-1, page 249; T. D. 3284, February 11, 1922.)

The general regulation as it stood prior to the issuance of the above Treasury Decision continues to govern the procedure in extraordinary cases. It reads:

Regulation. Where a delinquent return is filed by or on behalf of a person who is abroad,[21] an affidavit must be attached to the return, stating the cause of the delay in filing it, in order that the Commissioner may determine whether the failure to file the return in time was due to a reasonable cause and whether the return was filed without any unnecessary delay. If the showing justifies the conclusion that the failure to file the return in time was excusable, no penalty will be imposed. The installments of tax which are actually due must be paid at the time of filing the return and the other installments shall be paid as they fall due. In case an extension is granted, interest is payable at the rate of one-half of 1 per cent per month from the time

[21] **[Former Procedure]** Reg. 45, Art. 446, granted an extension for non-resident enemies or allies of enemies "for such period as may be neces-

the tax would have been due if no extension had been granted. (Art. 445.)

Place for filing returns.—In the case of individuals the law prescribes that:

LAW. Section 227. . . . . (b) Returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

An individual whose legal residence and principal place of business are not in the same district has the option as to which place he will file his annual return.

In the case of corporations, returns must be filed in the district in which is located the principal place of business of the corporation.

LAW. Section 241. . . . . (b) Returns shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.

RETURNS FILED BY MAIL.—Returns may be delivered either by hand or by mail.

REGULATION. . . . . If placed in the mails the return should be posted in ample time to reach the collector's office, under ordinary handling of the mails, on or before the date on which the return is required to be filed. If a return is made and placed in the mails in due course, properly addressed and postage paid, in ample time to reach the office of the collector on or before the last due date, no penalty will attach should the return not be actually received by such officer until subsequently to that date. Where a question may be raised as to whether or not the return was posted in ample time to reach the collector's office on or before the due date, the envelope in which the return was transmitted will be preserved by the collector and forwarded to the Commissioner with the return. (Art. 446.)

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sary, not exceeding ninety days after proclamation by the President of the end of the war with Germany." The latest date upon which returns were receivable under this extension was February 12, 1922. For further details see *Income Tax Procedure*, 1922, pages 60-63.

Period for which returns are made.—Returns of net income are ordinarily made for the "taxable year."[22] Only in unusual circumstances are returns made for a shorter period, such as when corporations are entering or going out of business, individuals or corporations are changing fiscal years, and in case of administrators who have made final accountings of estates.

"Taxable year" and "fiscal year" defined.—

Law. Section 200. . . . . (1) The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under section 212 or section 232. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December. The first taxable year, to be called the taxable year 1921, shall be the calendar year 1921 or any fiscal year ending during the calendar year 1921; . . . .

Fiscal year basis available to all taxpayers.[23]—All taxpayers, including individuals, have the privilege of keeping their accounts and reporting their income on the basis of a fiscal instead of the calendar year.

Law. Section 212. . . . . (b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be)[24] . . . . If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(c) If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 226.[25]

A newly organized business, whether incorporated or not,

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[22] Returns may not be made for a period exceeding twelve months (see page 85).

[23] [Former Procedure] The 1917 law extended to partnerships the fiscal year privilege given in the 1913 and 1916 laws to corporations. Individuals were not permitted to file returns on fiscal year basis until 1918.

[24] See section 218.

[25] See page 82.

may establish its fiscal year without securing the approval of the Commissioner.[26] In such a case the first return may or may not be for less than twelve months, depending upon the date of organization and the month selected as the close of its fiscal period.

In order to report on a fiscal year basis it is necessary under the specific terms of the law that the taxpayer keep books of account.[27]

FISCAL YEAR OF PARTNERS.—Many partners keep all their personal accounts, including income from investments, etc., in the books of the partnership. In such cases the partnership books are the books of each partner, and permission to make his personal returns on a fiscal year basis would be granted to a partner.

FISCAL YEAR RETURNS REQUIRED IF ACCOUNTS ARE KEPT ON THAT BASIS.—The 1918 law[28] established the rule that if the taxpayer kept his accounts on a fiscal year basis, he must use that basis in making his tax return, even though he had previously used a calendar year basis for his return, as, indeed, all individuals had previously been compelled to do. The 1921 law continues this rule.[29]

Recognition of accounting periods as taxable years.—A sharp distinction must be drawn between the procedure which applies in cases in which a fiscal year has already been established, and cases in which it is desired to change the accounting period and to have the newly established year accepted as the taxable year.[30]

[26] C. B. 2, page 67; O. D. 404.
[27] C. B. 3, page 81; O. D. 696.
[28] 1918 law, section 212 (b).
[29] All taxpayers have been on notice since February, 1919, regarding this rule. The Commissioner is given no discretion in enforcing it. If any taxpayer is still reporting on a calendar year basis when his books are kept on a fiscal year basis there has been a technical, but clear, violation of the law which should be adjusted as speedily as possible.
[30] Taxpayers making their first returns may do so on the basis of fiscal years if they have established such fiscal years. See page 78.

Recognition of existing fiscal year as "taxable" year.—The law provides no formality such as a notice to the collector[31] as a condition of the recognition of a fiscal year already established in the taxpayer's accounts. When any change is made in the taxable year, section 212 (b), quoted on page 76 provides that the net income "with the approval of the Commissioner" shall be computed on the basis of such new accounting period. But it has been ruled that the Commissioner's permission need not be specifically sought if the question is merely one of recognition of an existing status.[32] As will be seen from the following regulation, the fiscal year in such cases becomes established as the taxable year through the mere act of the taxpayer in reporting on that basis.

Regulation. The return of a taxpayer is made and his income computed for his taxable year, which means his fiscal year, or the calendar year if he has not established a fiscal year. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December. No fiscal year will, however, be recognized unless before its close it was definitely established as an accounting period by the taxpayer and the books of such taxpayer were kept in accordance therewith. The taxable year 1921 is the calendar year 1921 or any fiscal year ending during the calendar year 1921. . . . . A person having no such fiscal year must make return on the basis of the calendar year. Except in the case of a first return for income tax a taxpayer shall make his return of the basis (fiscal or calendar year) upon which he made his return for the taxable year immediately preceding unless, with the approval of the Commissioner, he has changed his accounting period. (Art. 25.)

Ruling. An individual who is sole proprietor of a business must compute his income from all sources on the same basis, and unless he maintains personal books of account in which his income from all business and other sources is reflected on the basis of a fiscal year

[31] [Former Procedure] Under the 1916 law, section 13 (a), notice was required of the day designated as the closing date of the fiscal year "not less than thirty days prior to the first day of March of the year in which its return would be filed if made on the basis of the calendar year." In the case of a change from a fiscal year to a calendar year, a thirty-day notice was required "prior to March 1 next following the closing date of the established fiscal year." (Reg. 33, 1918, Art. 217.) In the absence of notice fiscal year returns were not acceptable. (*Ibid.*, Art. 203.) Similar notice under 1913 law.

[32] C. B. 4, page 67; A. R. R. 391.

he does not have a fiscal year which can be recognized as the basis upon which his return may be made. (C. B. 4, page 71; O. D. 941.)

Various tests[33] have been stated to determine what constitutes the end of an accounting period (and consequently, whether or not the taxpayer is on a fiscal year basis), such as reference thereto in the by-laws, annual statements submitted to stockholders for dividend purposes, collection period and convenient periods for accounting purposes. Under the law, the ultimate test would seem to be the taking of a complete and accurate inventory. Without such inventory there can be no real closing of the accounts. The weight of accounting authority is that the proper termination of the "accounting cycle," as Professor Kester phrases it, requires a correct inventory.[34] In numerous cases taxpayers have continued to make returns on a calendar year basis after 1917, closing their books during the year as well as at December 31. If physical inventories were properly taken at December 31, it can be said that such inventories constituted the basis for a proper closing on a calendar year basis.

In a recent case, where the taxpayer desired to change from calendar to fiscal year basis in 1918, permission was refused because an inventory had not been taken and the books had not been closed at the end of June 30, 1918.

RULING. From the evidence submitted it appears that up to and including 1917 the appellant corporation kept its books on a calendar-year basis and filed its returns on this basis. After the books had been closed on December 31, 1918, the corporation had a firm of certified public accountants make an audit of its books. The accountants found that the inventories had been taken at cost and no consideration had been given to the market values. As the market was in an unsettled condition at this time, the accountants were of the opinion that the book results did not reflect the appellant's true profit. After discussing the matter on several occasions with the local collector of internal revenue, it was decided that the proper procedure to adopt for the purpose of taking care of the situation was to apply

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[33] C. B. 4, page 69; A. R. R. 501.

[34] See also Jordan and Harris, *Cost Accounting,* 1920, page 165; Paton and Stevenson, *Principles of Accounting,* page 155.

for permission to change from a calendar to a fiscal year basis in making the corporation's returns. This was done in February. It is contended that, as Regulations 45 were not then in existence, article 211 of Regulations 33 (revised) prevailed, and are the regulations that should guide the appellant corporation in the instant case.

Without discussing the question as to whether or not articles 25 and 26 of Regulations 45 are retroactive (said articles would not permit the change as requested), attention is called to the fact that the company made application in February, 1919, designating June 30, 1918, as the date of its closing period for the year. The books were not formally closed as of such date and inventory was not taken until December 31, 1918. Inasmuch as the books were not formally closed as of that date, the principle laid down in Tax Board Recommendation 37 (C. B. 1, pages 63 and 64) applies in this case. The Tax Board stated:

> In this case sufficient reason has not been given to depart from the general rule that a taxpayer once having returned upon the basis of the business year best adapted to reflect the true income should not be permitted to depart from that return year, that in the ordinary case change in the return year for the purpose of modifying the tax should be discouraged, and should be permitted only for sound business reasons *following an accomplished change in the accounting period actually employed in keeping the books of the taxpayer.* [Italic is the Committee's.] (I-33-456; A. R. R. 1052.)

Recognition of a changed accounting period as a taxable year.—When taxpayers desire to *change* from one accounting period already established and recognized for tax purposes to some other period, they must give a thirty-day written notice and their reasons for the intended change. It is quite proper that changes of this character should be made subject to the approval of the Commissioner, for taxpayers should not be free to change frequently and arbitrarily from one fiscal year to another. Changes are granted by the Commissioner only through the local collectors of internal revenue.[35] The application must be made by the taxpayer directly interested or by his duly authorized agent. If the latter makes the application, the authority to act for the taxpayer must be produced.[36]

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[35] C. B. I-1, page 57; Mim. 2927.
[36] C. B. 4, page 71; Mim. 2738.

When is change in fiscal year "established"?—After having secured the permission of the Commissioner to change the basis of his return, a taxpayer may for some reason wish to continue to report on the basis of the old accounting period. The taxpayer may discover that it is not practicable to prepare his return on this new basis, or he may discover that there are certain conditions which he failed to consider when he applied for a change. If he fails to report on this new basis, will he be subject to penalties?

There appear to be two things required to bring about a change: (1) the approval of the Commissioner must be secured, and (2) the change must actually be made and a return filed on the new basis. The law says that the Commissioner may approve changes in accounting periods, but it does not provide that he may create new accounting periods; therefore penalties cannot be imposed unless a new accounting period has been fully established.

The Treasury has held, however, that if application to make a change is made by the taxpayers and is authorized, the change *must* be made.[37] It is difficult to discover under what provision of the law the Treasury can force a taxpayer to make a change in his accounting period if an intention to change has not been made effective in the taxpayer's books. A taxpayer may apply for authority to change his accounting period with the intention of making such a change if and when the permission is received. In the interval between making the application and receiving the authorization, circumstances may arise which cause the taxpayer to alter his desire to change. There is no provision of the law which can force the taxpayer to make the change. An actual change must be made and a return must be filed on the new basis before the taxpayer loses his right to continue the old accounting period.

In a specific case, upon giving good reason therefor a tax-

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[37] *Ibid.* See also C. B. I-1, page 57; Mim. 2927.

payer was permitted to return to the old basis although a change had previously been authorized.[38]

Fiscal years fixed by state legislatures.—If a state wishes to change the accounting period of public service corporations, it is not necessary for taxpayers to secure the permission of the Commissioner to report on the new basis.[39]

It seems to follow that, if a state wished to fix the fiscal years of all corporations created by that state, which it could no doubt do, such corporations would be obligated to report on this new basis, and it would not be necessary to secure the permission of the Commissioner. The approval of the Commissioner appears to be necessary only when the taxpayer voluntarily changes his fiscal year.

Return when accounting period is changed.—

Law. Section 226. (a) That if a taxpayer, with the approval of the Commissioner, changes the basis of computing net income from fiscal year to calendar year a separate return shall be made for the period between the close of the last fiscal year for which return was made and the following December 31. If the change is from calendar year to fiscal year, a separate return shall be made for the period between the close of the last calendar year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year a separate return shall be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year.[40]

(b) In all cases where a separate return is made for a part of a taxable year the net income shall be computed on the basis of such period for which separate return is made, and the tax shall be paid thereon at the rate for the calendar year in which such period is included.

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[38] [Former Procedure] If a taxpayer made a change in his accounting period during 1918, the approval of the Commissioner was not necessary. The Revenue Act of 1918 was not approved until February 24, 1919; so any changes made prior to the passage of the law, whether from calendar to fiscal year or vice versa, were confirmed thereby. (C. B. 3, page 81; A. R. R. 342.)

[39] C. B. 1, page 62; O. D. 100.

[40] [Former Procedure] The following ambiguous and unnecessary provision of the 1918 law was not re-enacted in the 1921 law:

1918 Law. Section 226. . . . . If a taxpayer making his first return for income tax keeps his accounts on the basis of a fiscal year he shall make a separate return for the period between the beginning of the calendar year in which such fiscal year ends and the end of such fiscal year. . . . .

(c) In the case of a return for a period of less than one year the net income shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in such period; and the tax shall be such part of a tax computed on such annual basis as the number of months in such period is of twelve months.[41]

The foregoing provisions place net income on an annual basis and have the effect of subjecting such income to a higher surtax rate than was the case under the former method of computation. The law now applies to the net income the same high rates as would be the case if income throughout the year were received at the same rate as during the fractional period. An illustration of the increased tax payable under the new method of computation is given in Chapter IX.[42]

NOTICE TO COMMISSIONER REQUIRED.—

REGULATION. If a taxpayer changes his accounting period he shall as soon as possible give to the collector for transmission to the Commissioner written notice of such change and of his reasons therefor. The Commissioner will not approve a change of the basis of computing net income unless such notice is given 30 days before the close of the proposed or new taxable year or period. The due date of the separate return for such period is the fifteenth day of the third month following the close of that period. If the change in the basis of computing the net income of the taxpayer is approved by the Commissioner, the taxpayer shall thereafter make his returns and compute his net income upon the basis of the new accounting period. . . . . (Art. 26.)[43]

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[41] [Former Procedure]

1918 LAW. Section 226. . . . . In all of the above cases the net income shall be computed on the basis of such period for which separate return is made, and the tax shall be paid thereon at the rate for the calendar year in which such period is included; and the credits provided in subdivisions (c) and (d) of section 216 shall be reduced respectively to amounts which bear the same ratio to the full credits provided in such subdivisions as the number of months in such period bears to twelve months.

The credits which must be prorated [section 216 (c) and (d)] are the $1,000 or $2,000 exemptions and the $200 credits for dependents.

[42] It was not necessary to apply these provisions to corporations in determining the excess profits tax, the same result being achieved by the pro rata reduction of invested capital and specific exemptions.

[43] [Former Procedure] Since the 1916 law and the 1917 amendments thereto specifically provided that all returns must be made on a calendar year basis, unless a fiscal year was designated according to the provisions of the law, any changes made in the accounting period during 1918 or subsequently cannot affect any returns, calendar or fiscal, made for the year

The local collectors are given the following directions regarding the detailed information required from applicants for changes:

RULING. Applications from taxpayers requesting permission to change their accounting period must be addressed to the Commissioner of Internal Revenue, but should be filed with the collector of the district for transmission to the Commissioner. It is necessary that each application be carefully examined by collectors of internal revenue to see that the necessary data are furnished before forwarding to this office in order that action thereon may be expedited and the necessity for requesting additional information be avoided.

In order that this office may act upon a request for a change in accounting period, it is essential that the following data be furnished by the taxpayer:

1. Whether the business is conducted by a corporation, a partnership, or an individual.

2. The taxpayer, if other than an individual, must state (*a*) the exact date upon which business was actually commenced, and (*b*) if incorporated, the date of incorporation.

3. The basis on which books have been kept each year since January 1, 1918, specifically setting forth for each year opening and closing dates.

4. The exact period covered by each return filed since January 1, 1918, specifically setting forth for each year the beginning and ending dates of the period.

5. State fully the reasons why the change is desired. As these changes are not lightly to be considered, the taxpayer should bear in mind that if a change is authorized he will be required thereafter to make returns on the basis of the new accounting period.

6. If incorporated, and a member of a consolidated group under section 240, Revenue Act of 1921, which elects to file a consolidated

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1917. It also follows that the Commissioner is without power to accept amended returns for the year 1917 on the basis of a changed accounting period.

RULING. A corporation having kept its accounts on a fiscal year basis, and not having made application for permission to change to a calendar year basis until July 6, 1920, will not be permitted to file its returns on the calendar year basis for the years 1918 and 1919. (C. B. 4, page 67; Digest A. R. R. 391.)

Under Art. 26 of Reg. 45, notice had to be given at a time which was both (a) thirty days before the due date of the taxpayer's return on its existing basis, and (b) thirty days before the due date of the return for the period between the end of his existing taxable year and the end of the proposed taxable year. The Treasury held that in the case of a taxpayer who filed a return for a fiscal year ended June 30, and desired to change to a calendar year basis, notice must be given at least thirty days prior to March 15 of the following year. (C. B. 2, page 67; Sol. Op. 5.)

return, state names of affiliated corporations and basis upon which affiliation is effected.

Individuals reporting on a calendar year basis and making application to change to a fiscal year basis must show that they keep books of account or other competent records in which is accurately reflected all income from whatever sources derived, and that it is the intention to maintain and close such books on the fiscal year basis proposed.

Power of attorney executed in due form must be furnished by any individual, firm, or corporation representing any other individual, firm, or corporation in applying for change of accounting period. . . . . (C. B. I-1, page 57; Mim. 2927.)

Change of fiscal year to obtain greater advantage from net loss provision.—Section 204 (b) of the 1921 law provides that if a taxpayer sustains a net loss, it may be deducted from the net income of the next succeeding two years ending after December 31, 1920.[44] Subdivision (d) of the same section provides that in the case of a fiscal year beginning in 1920 and ending in 1921, the taxpayers shall be entitled to the benefits of the net loss provision in proportion to the part of such fiscal year falling in 1921.

It is quite conceivable that a future shifting of fiscal year dates may result in reduced taxes. It may also result in increased taxes. The law regarding changes in fiscal periods is clear, so that no retroactive shifting is possible. With the lower rates of tax and the prospect for continued change in the tax laws, fiscal-year shifting to save taxes would not be worth much thought.

Return must not cover period exceeding twelve months.—Throughout the law reference is made to a taxable year or to a calendar year and to parts of a taxable year, and it is stated that a fiscal year means an accounting period of twelve months.[45] In no case is there a specific prohibition in the law against a return covering a period of more than

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[44] [Former Procedure] Section 204 (b) of the 1918 law enacted a somewhat similar, but much more restricted, net loss provision. See *Income Tax Procedure*, 1921, page 783, *et seq.*

[45] Section 200.

twelve months; but the direction to file for a year or less would be held to be a prohibition. A regulation specifically prohibits the use of a period of more than twelve months.

REGULATION. No return can be made for a period of more than twelve months. . . . . (Art. 431.)

Blank forms for returns.—Returns must be made in the form prescribed by the Commissioner, with the approval of the Secretary of the Treasury. Blank forms are mailed to taxpayers on the records, without special request, but failure to receive forms does not excuse taxpayers from reporting in due season. If the forms are not received in ample time to file on or before the due date, application for copies should be made to the office of the local collector, to any bank or post-office or, as a last resort, directly to the Commissioner in Washington.

Taxpayers should retain exact copies of returns as filed. The forms used for several years past for individual returns of $5,000 and over have included a duplicate sheet as an integral part of the return, which obviates the necessity of securing an extra copy of the form. In the case of forms which do not include duplicate sheets, taxpayers should secure extra blanks for copies.

REGULATION. Copies of the prescribed return forms will so far as possible be furnished taxpayers by collectors. Failure on the part of any taxpayer to receive a blank form will not, however, excuse him from making a return. . . . . In lack of a prescribed form a statement made by a taxpayer disclosing his gross income and the deductions therefrom may be accepted as a tentative return, and if filed within the prescribed time a return so made will relieve the taxpayer from liability to penalties, provided that without unnecessary delay such a tentative return is replaced by a return made on the proper form. . . . . (Art. 407.)

FORMS FOR 1923.—Form 1040 will be used in 1923 by individuals whose net income exceeds $5,000; for the separate returns of husband and wife when the combined net incomes exceed $5,000; for returns covering less than a year when the

net income placed on an annual basis exceeds $5,000; and when the individual's net income exceeds $4,000 and the entire family exemption is taken in a separate return filed by husband or wife.

Form 1040A, with the exceptions noted above, will be used in cases where the net income of individual taxpayers is less than $5,000.

Form 1041 will be used for filing returns of fiduciaries,[46] form 1065 for partnerships, and form 1120 for corporations.

Failure to make return—collector to supply deficiency.—

LAW. Section 1311. [Section 3176, Rev. Stat.] If any person, corporation, company, or association fails to make and file a return or list at the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commissioner, or by a collector or deputy collector and approved by the Commissioner, shall be prima facie good and sufficient for all legal purposes. . . . .

Accordingly, in cases where the collector or Commissioner makes a return, the amount of tax determined under the substitute return is payable upon notice and demand.

Amended returns.—The necessity for an amended return or its equivalent may arise from an examination by the Treasury or from a discovery by the taxpayer of some item which stands in need of correction. Examinations by the Treasury and additional assessments resulting therefrom are fully treated in Chapter XI. In general it is no longer the practice of the Treasury to require taxpayers to file formal amended returns to correct errors found by the Treasury in

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[46] See Chapter XLII for the use of other forms by fiduciaries.

the course of the audit.[47] The procedure now is for the Treasury itself to prepare the equivalent of an amended return on which the adjusted tax is based and to inform the taxpayer of the reasons for the additional assessment. See Chapters XI and XII.

When a taxpayer desires to file an amended return, the Treasury prefers that he request permission, stating his reasons. It is obvious that when cases come up for examination, those that have attached letters from the Commissioner granting such permission will receive better consideration than those without such permission, because to some extent at least the changes between original and amended returns will have been already passed upon by the Treasury. But the formal refusal by the Treasury to sanction amended returns should not be deemed to be final in meritorious cases. If the formal consent is withheld, it would seem to be proper procedure for the taxpayer to prepare corrected returns[48] and file them with his local collector who should not refuse to accept them for transmission to the Commissioner.

Amended returns are not to be filed to correct trifling omissions or mistakes.—All business concerns and all individuals have items of receipts and expenses which cannot be incorporated in books of account prior to closing time. In the well-managed concern the amounts are usually insignificant and when subsequently ascertained they are entered as current items in the succeeding period. If the amounts are large, the treatment is different and adjustment of the accounts of the prior period and the filing of amended returns are in order; but after the accounts for a fiscal year are once closed there should be no reopening

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[47] **[Former Procedure]**

Regulation. . . . . If in the opinion of the Commissioner such information indicates that the returns for any previous years did not reflect the true income, amended returns for such years will be required. . . . (Reg. 45, Art. 23.)

[48] When amended returns for 1916 and years prior are filed, the form prescribed for the year 1916 should be used.

unless it is a matter of substantial importance. In cases where adjustments are necessary but where the items are few, a statement showing the recomputation of tax is sufficient. If the adjustments show an additional tax, the Commissioner will in due course make an assessment. Where an overpayment is shown, the statement should be attached to either a claim for refund or a claim for credit.

The regulations specifically prescribe amended returns in certain contingencies.

Regulation. . . . . If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from gross income, he may render an amended return for such preceding taxable year including such amount of loss in the deductions from gross income and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return. . . . . (Art. 111.)

Ruling. A corporation may submit amended returns for previous years when through wrong accounting practice capital charges have been made to income. An affidavit should be attached, explaining the changes made by such amended returns in the amounts shown on the original return, and explaining why the original returns were not properly prepared and the object of the company in preparing amended returns. Such amended returns will be accepted only when the erroneous charge can be specifically pointed out and the facts proven. The Internal Revenue Bureau reserves the right to penalize for the making of false returns in the past. (C. B. 1, page 234; O. D. 113.)

Railroads are directed to use amended returns in making adjustments in items for previous years under direction of the Interstate Commerce Commission.[49]

Ruling. Reference is made to your letter of June 2, 1920, in which you state that during the years 1915, 1916 and 1917 . . . . Company paid customs duties on imported merchandise on the basis of an exchange rate of a franc at 19.3 cents instead of the lower rate prevailing at the time of importation. It appears that the amount so paid as duties were included in the income and profits tax returns as part of the cost of goods sold during the years 1915, 1916 and 1917 and the surplus reduced each year to the extent of the duties paid. During the year 1919 the company received a refund of the amount so paid as customs duties which was in excess of the amount due on

[49] C. B. 1, page 58; O. D. 9.

the basis of the exchange rate prevailing at the time of importation of the French merchandise.

You submit for consideration the following inquiries relative to the treatment of the transaction for income tax purposes:

(a) How should the transaction be treated in computing the annual net income for the years involved?

(b) Is not the amount allowed as a refund for duties overpaid in each year a credit to surplus for that year?

(c) Is not the attorney's fee and expense of collection an item of necessary business expense incurred in 1919 when the liability accrued and was paid?

In reply you are advised that the law contemplates that each year's return both as to gross income and deductions therefrom shall be complete in itself. The effect of the Treasury Decision under which the claim for refund of excess duties paid was allowed is to indicate that the excess revenue, which was paid during the years 1915, 1916 and 1917 and for which the company received a refund during the year 1919, is an amount which has been erroneously deducted in computing net income for the years 1915, 1916 and 1917 respectively rather than an amount which represents income for the year 1919.

Accordingly the company should amend its returns for the years 1915, 1916 and 1917, respectively, excluding from the cost of goods sold during each year the excess duties paid during such year. The surplus account for those years should also be adjusted by restoring to such account the amount paid as revenue in excess of the true liability for those years.

The attorney's fees and cost of collection of the refund are a necessary business expense for the year in which the liability accrued and was paid, which appears to be the year 1919. (Letter to S. D. Leidesdorf & Company, New York, N. Y., signed by Paul F. Myers, Acting Commissioner, and dated June 26, 1920.)

AMENDED RETURNS—COMMUNITY PROPERTY.—Those taxpayers who have not taken advantage of the decision on community property[50] are still entitled to file amended returns so as to give effect to the treatment of community property[51] as separate property of husband and wife.

AMENDED RETURNS TO BE MADE BY OFFICERS OF CORPORATION IN HANDS OF TRUSTEES.—

RULING. In the return of the M Company for the year 1920 no depreciation was claimed on the buildings and machinery. The plant

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[50] See Chapter XVI.

[51] C. B. 3, page 309; O. D. 708.

of the company has not been operated for over a year and is now in charge of trustees under a trust deed securing a bond issue which is being foreclosed. Inquiry is made whether the trustees may file an amended return for 1920 showing depreciation and also file claim for refund.

Held, that an amended return for 1920 can not be filed by the trustees, but must be submitted by the principal officers of the corporation, who may also file a claim for refund of any overpayment of tax made in 1920. (I-38-513; I. T. 1450.)

Tax adjustment when amended returns for 1913-1916 are filed.—Until December 31, 1916, federal income taxes were deductible in arriving at taxable income. Therefore when an amended return results in a change in the amount of the tax for 1916 or prior years, there is required a corresponding adjustment of net income in the succeeding year equal to the refund received or additional payment made. This is usually done by setting up a statement showing all adjustments of income on the corrected basis and including the corrected tax of previous years as a deduction in succeeding years.

Tax shown by amended returns—payable when?—Generally speaking, additional taxes shown by an amended return are not payable until they have been assessed by the Commissioner. Aside from those cases arising under T. D. 3220,[52] the procedure is that collectors forward the returns to the Commissioner, and after the returns have been audited, assessments, if any, are sent to the collector, who in due course demands payment.

[52] C. B. 5, page 285.

CHAPTER V

RETURNS OF INDIVIDUALS AND CORPORATIONS

The preceding chapter explains who must make returns, when they must be made, the period they must cover, and other related matters. A detailed description of the specific procedure to be followed by individuals, partnerships, and corporations in filing their annual returns now follows.[1]

Annual Returns by Individuals

Who shall make returns.—

LAW. Section 223. **(a) That the following individuals shall each make under oath a return stating specifically the items of his gross income and the deductions and credits allowed under this title.—[2]**

(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife;

(2) Every individual having a net income for the taxable year of $2,000 or over, if married and living with husband or wife; and

(3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income.[3] . . . .

REGULATION. . . . . Whether or not an individual is the head of a family[4] or has dependents is immaterial in determining his liability to render a return. If an individual is a married person living with husband or wife, no return need be made unless their aggregate gross income is at least $5,000 or their aggregate net income is at least $2,000; but a separate return must be made by each of them, regardless of the amount of the individual income of each, where their aggregate gross income is $5,000 or over, or their aggregate net income is $2,000 or over, unless they join in a single joint return. Where the income of each is included in a single joint return, the tax is computed on the aggregate income and all deductions and credits to which

[1] A discussion of returns of affiliated corporations appears in Chapter VI.

[2] See page 47.

[3] **[Former Procedure]** This requirement appeared for the first time in the 1921 law.

[4] For definition of "head of a family," see Chapter XV.

either is entitled shall be taken from such aggregate income. The husband shall include in his return the income derived from services rendered by the wife or from the sale of products of her labor if she does not file a separate return or join with him in a return setting forth her income separately. . . . . (Art. 401.)

It is apparent that the only individual who can take advantage of the permission to refrain from reporting when his net income exceeds $1,000 but is less than $2,000 (and whose gross income together with that of his wife is less than $5,000) is one who is "married and living with husband or wife." Heads of families who are unmarried[5] must report when they have net incomes in excess of $1,000 even though, because of dependents, they may have "credits" enough to cancel all their income above that amount.

It should be noted that the terms "net income" and "gross income" are used, so that dividends, exemptions for dependents, and other "credits" may not be deducted from the amount which determines whether or not a return is to be made.[6] Thus there are undoubtedly many individuals who are required to make returns who, after they have applied all their "credits,"[7] have no tax to pay.

"Gross income" of individuals defined.—

Rulings. For the purpose of section 223 of the Revenue Act of 1921 gross income in the case of a taxpayer engaged in merchandising means total sales, less cost of goods sold, plus any income from investments and from incidental or outside operations or sources. (C. B. I-1, page 234; Digest I. T. 1241.)

. . . . A lawyer, who is married and living with his wife, has gross receipts in the form of fees amounting to $6,000, and his necessary business expenses amount to $4,200, leaving a net income of only $1,800. A return would be required in this case, as the taxpayer's gross income as well as gross receipts is $6,000. . . . . (C. B. I-1, page 233; Mim. 2915.)

Individuals whose entire income is derived from interest on tax-exempt securities enumerated in section 213 (b-4)

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[5] See Chapter XV.
[6] See Chapter XV.
[7] Section 216.

need make no return.[8] They do not come under the provision of section 223 (a-3) requiring a return where the gross income is $5,000 or over, because such tax-exempt interest is expressly excluded from gross income. In fact, taxpayers are no longer asked to make any report of income from tax-exempt securities.[9]

Return may be filed by agents—when.—

LAW. Section 223. . . . . **(c) If the taxpayer is unable to make his own return, the return shall be made by a duly authorized agent or by the guardian or other person charged with the care of the person or property of such taxpayer.**

REGULATION. . . . . The return may be made by an agent when by reason of illness, absence, or nonresidence the person liable for the return is unable to make it, the agent assuming the responsibility for making the return and incurring liability to the specific penalties provided for erroneous, false, or fraudulent returns. . . . . (Art. 402.)

The instructions on the form of the personal return state further that the agent may act when the taxpayer is "a minor or incompetent."[10]

"AGENT" DEFINED.—

REGULATION. There may be a fiduciary relationship between an agent and a principal, but the word "agent" does not denote a fiduciary. A fiduciary relationship can not be created by a power of attorney. An agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary within the meaning of the statute. In cases where no legal trust has been created in the estate controlled by the agent and attorney the liability to make a return rests with the principal. (Art. 1522.)

Fiduciaries use form 1041. An agent uses the form which his principal would file if able to do so in person, usually form 1040.

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[8] C. B. I-1, page 231; I. T. 1223.

[9] **[Former Procedure]** Section 213 of the 1918 law called for a statement of such income.

[10] Form 1040A (1922), instructions.

Return must be under oath.—The law requires that "every person liable to any tax imposed by this Act, or for the collection thereof, shall . . . . render, under oath, such statements and returns . . . . as the Commissioner, with the approval of the Secretary, may from time to time prescribe."[11]

The following regulation gives instructions for executing an affidavit:

REGULATION. All income tax returns must be verified under oath or affirmation before an officer duly authorized to administer oaths either by the laws of the United States or by the laws of the State or Territory where such officer resides. Persons in the naval or military service of the United States may verify their returns before any official authorized to administer oaths for the purposes of those services. Income tax returns executed abroad may be attested free of charge before United States consular officers. Where a foreign notary or other official having no seal shall act as attesting officer, the authority of such attesting officer should be certified to by some judicial official or other proper officer having knowledge of the appointment and official character of the attesting officer. (Art. 406.)

The Treasury has held that oaths should be administered by officers having general rather than specific authority. Postmasters, it was held, cannot therefore properly administer oaths for income tax purposes.[12]

In some states notaries are required, and in other states they are not required, to authenticate their certificates with their notarial seals. A summary of the requirements of various states will be found in I-41-544; I. T. 1467.

Separate returns of husband and wife.—

LAW. Section 223. . . . . **(b) If a husband and wife living together have an aggregate net income for the taxable year of $2,000 or over, or an aggregate gross income for such year of $5,000 or over—**

(1) Each shall make such a return, or

(2) The income of each shall be included in a single joint return, in which case the tax shall be computed on the aggregate income. . . . .

Under the foregoing provision, the requirement that a return must be filed where the gross income is $5,000 or over,

[11] Sention 1300. For verification of corporation returns, see Chapter IX.
[12] C. B. 3, page 228; O. D. 701.

is made to apply to the *aggregate gross income of husband and wife* when they are living together.

If husband and wife are not living together, and if the net income of each is $1,000 or more, separate returns must be made.

If husband and wife, living together, elect to make a single joint return, the tax "shall be computed on the aggregate income."[13] The privilege of applying one spouse's loss or deductions against the other's income may be availed of in the making of a single joint return.

It is well to remember that, when husband and wife are living together, they have the option each year of filing either joint or separate returns.

RULINGS. A husband and wife may elect to file a joint return one year and separate returns the next, regardless of whether such election results in a benefit to them or a benefit to the Government. (C. B. 5, page 195; O. D. 968.)

Where husband and wife clearly indicate on a single return form the net income of each and computes the tax on the basis of such separate income, the return so filed does not constitute a joint return, but the separate return of each individual. Where, however, a single return form is used clearly indicating the separate net income of husband and wife but the tax is computed upon the basis of combined income, such return is a joint return. (C. B. 4, page 255; Digest O. D. 960.)[14]

WHEN DESIRABLE.—In practically every case where a husband and a wife have a substantial income, separate returns should be filed in order that the surtax may be applied separately.

It is not necessary to file a separate form for the husband and the wife to secure the benefit of the calculation if care is used to segregate the income and deductions of each, but usually it is better to file the two forms.[15]

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[13] **[Former Procedure]** This phrase was not included in the 1918 law.

[14] In cases where community property is divided between husband and wife, separate returns must be filed. See page 101.

[15] **[Former Procedure]** The Treasury has not always assessed the surtax separately, but has in some cases levied and collected an excessive tax which would not have been imposed if separate returns had been made.

In case husband and wife each received an independent net income equal to or in excess of $1,000, separate returns may be made, but a joint return will ordinarily serve unless the combined net income exceeds $6,000. When the net income for 1922 shown in a return exceeds $6,000, the surtaxes begin to apply. By rendering separate returns the application of the suxtaxes is forestalled to the extent of an additional $6,000.[16] Below that figure the taxes would, with two exceptions, be the same even though the incomes were merged, i.e., 4 per cent of the amount by which the total net income exceeded the "credits," whether individual returns or a joint return were filed.

The exceptional cases in which a combined return is desirable even though the incomes are substantial may arise (a) when the husband or wife has allowable charitable contributions in excess of the 15 per cent limitation, full credit for which would be lost if separate returns were made, and (b) when one spouse has a net loss which may be applied against the income of the other.

Ruling. Receipt is acknowledged of your letter of January 17th, 1921, in which you state that during the year 1920 your income was approximately $54,000.00. During the same period your wife suffered a net loss of $62,000.00.

You request to be advised whether under the circumstances you and your wife may file a joint return for the purpose of applying your wife's net losses against your income.

You are advised that there is no provision of the law by which a husband and wife can be denied the privilege of filing a joint return. Your wife's net losses may therefore be deducted from your income in determining income subject to both the normal tax and the surtax where you and your wife elect to file a joint return. (Letter signed by Commissioner Wm. M. Williams, and dated February 3, 1921.)

In addition to the surtaxes, which begin to apply when a net income reaches $6,000, there is also the 8 per cent normal rate which applies in place of the 4 per cent rate when the ex-

[16] [Former Procedure] Before 1922 surtaxes began to apply at $5,000. See Chapter IX.

cess of net income over credits (personal exemptions, dividends, etc., see Chapter XV) is greater than $4,000.

To illustrate, in the case of a married man (citizen or resident of the United States) with no dependents, having a net income of $40,000 for 1922 (none from dividends), if a joint return is filed, the tax is arrived at thus: He receives an exemption of $2,000, pays a normal tax of 4 per cent on the next $4,000, and 8 per cent on $34,000. The surtax begins at $6,000 and is 1 per cent on the first $4,000 in excess of that amount, graduating upward until it reaches 17 per cent on the last $2,000 of the $40,000. The normal tax is $2,880 and the surtax $2,960, a total of $5,840. In this instance the surtax at 1922 rates is $450 less than at 1921 rates.

Assume, instead, that the husband and wife have each an income of $20,000 and an exemption of $1,000, and file separate returns. The normal tax for each is then 4 per cent on the next $4,000, and 8 per cent on $15,000. Surtax begins as before at $6,000, and runs to 6 per cent on the $2,000 between $18,000 and $20,000. The tax for each is: normal $1,360, surtax $440; total $1,800. The combined tax is $3,600. A saving of $2,240 is secured by making separate returns.

When wife should take no part of personal exemption.—In a case like the following, a wife should take no personal exemption.

Husband's income $20,000; wife's income $4,000; 3 children

Method A—wife takes exemption:

		Tax
Wife's income	$4,000.00	
Less: Exemption	2,000.00[17]	
Taxable at 4 per cent.	$2,000.00	$80.00

[17] The personal exemption is $2,000, not $2,500 since the *aggregate* net income of husband and wife is $24,000. See section 216 (c), Chapter XV.

Husband's income	$20,000.00		
Less: Exemption (three children)	1,200.00		
	$18,800.00		
Taxable at 4 per cent.	4,000.00	160.00	
Taxable at 8 per cent.	$14,800.00	1,184.00	
Combined normal tax			$1,424.00

METHOD B—HUSBAND TAKES EXEMPTION:

Wife's income—taxable at 4 per cent.	$4,000.00	$160.00	
Husband's income	$20,000.00		
Less: Exemption	3,200.00		
	$16,800.00		
Taxable at 4 per cent.	4,000.00	160.00	
Taxable at 8 per cent.	$12,800.00	1,024.00	
Combined normal tax			1,344.00
Saving in normal tax = 4 per cent on exemption of $2,000 =			$ 80.00

It is clear from the above example that if a wife has an income of $4,000 or less, and the husband has an income which, after deducting the full personal exemption, is large enough to subject some of it to the 8 per cent normal tax, the application of the entire personal exemption to the husband's income results in a saving equal to 4 per cent of the exemption.

JOINT RETURNS DO NOT REDUCE LIBERTY BOND EXEMPTIONS.—If husband and wife each own, for example, $5,000 of Liberty bonds, the making of a joint return does not deprive each from claiming the interest thereon as tax-exempt.[18]

Community property.—The Attorney General, in opinions dated September 10, 1920,[19] and February 26, 1921,[20] has held that community income as defined by the laws of Texas, Washington, Arizona, Idaho, New Mexico, Louisiana, and

[18] See Chapter XXV.
[19] C. B. 3, page 221; T. D. 3071; 32 Op. A. G. 298.
[20] C. B. 4, page 238; T. D. 3138; 32 Op. A. G. 435.

Nevada (but not California) may be equally divided between husband and wife. The use of separate returns by husbands and wives in these states will often result in a considerable saving of taxes. A discussion of community property will be found in Chapter XVI.

In all cases of residents of the states where the rule applies, amended returns for previous years and claims for refund may be filed within the five-year period laid down by the 1921 law.

RULING. Amended separate returns may be filed for each of the taxing years in which the law of Texas contains a provision giving husband and wife equal rights to community property, subject to five-year limitation in section 252, Revenue Act of 1918.

Claim for credit of net amount of taxes overpaid for any of the taxing years may be filed for the amount of assessment outstanding and claim for refund filed for balance. Claim for abatement instead of claim for credit, however, should be filed for excess of tax assessed for 1919 over tax due for 1919 under amended separate returns. Claim for refund may be filed for entire net overpayment if no assessment is outstanding. Adjustment of taxes between husband and wife due on amended separate returns will be made as a matter of accounting and no claim for credit should be filed.

Any claim for abatement, refund, or credit must be accompanied by an agreement signed by husband and wife consenting to adjustments therein demanded.

In all cases in which it appears that returns are filed as a result of the ruling contained in Treasury Decision 3071,[21] and the income shown in the returns now filed was disclosed in a prior return or returns, penalty on account of delinquency will not be asserted and interest on account of failure to pay the tax shown by the returns on the date payment was required by law, will not be assessed. Where a claim for credit is filed under this ruling, bond will not be required.

Claims for credit may be filed for unpaid additional taxes assessed under office ruling 43-20-1270.[22]

Should the above outlined procedure not cover any specific case which may arise, the facts therein should be presented to this office for a specific ruling. (C. B. 3, page 310; O. D. 757.)[23]

The above ruling under the 1918 law applies specifically to Texas, but it applies equally well to the other states hav-

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[21] See Chapter XVI.
[22] C. B. 3, page 309.
[23] Also see C. B. 1-1, page 302; I. T. 1154.

ing community property laws (listed above). The claims are now made under section 252 of the 1921 law.

With the amended returns a claim for refund, credit, or abatement must be filed in order to adjust the excess tax paid by one spouse. Although the ruling is not commendable for its clarity, a subsequent decision[24] confirms the inference that underpayment by one spouse may be offset against overpayment by the other. Claim is to be filed for the excess.

Change of domicile to another state in later years does not affect the right to render amended returns,[25] nor does it cause the forfeiture of the right to file separate returns of income from community property acquired while domiciled in the first state.[26]

PERSONS ELECTING TO REPORT ON THE COMMUNITY-PROPERTY BASIS MUST FILE SEPARATE AND NOT JOINT RETURNS.—

RULING. Office Decision 960 (C. B. 4, p. 255) is not applicable to returns filed on a community property basis. Separate returns must be filed by husband and wife where the community income is divided between them. (C. B. I-1, page 235; I. T. 1283.)

The foregoing ruling is questionable. If the Commissioner has no power to deny to husband and wife (who own separate property in other states) the right to file joint returns,[27] it is hard to understand why husband and wife who happen to live in Texas do not have the same right.

Returns by minors.—Minors in receipt of taxable income are required to make returns, or returns must be made for them.

REGULATION. An individual under the statutory age of majority is required to render a return of income if he has a net income of his own of $1,000 or over, or a gross income of $5,000 or over, for the

[24] C. B. 4, page 335; O. D. 854.
[25] C. B. 4, page 235; O. D. 810.
[26] C. B. 5, page 197; Sol. Op. 121.
[27] See page 97.

taxable year.[28] If he is married, see article 401.[29] If a minor has been emancipated by his parent his earnings are his own income, and such earnings, regardless of amount, are not required to be included in the return of the parent. If the aggregate of the net income of a minor from any property which he possesses, and from any funds held in trust for him by a trustee or guardian, and from his earnings in case he has been emancipated, is at least $1,000, or his gross income is at least $5,000, a return as in the case of any other individual must be made by him or by his guardian, or some other person charged with the care of his person or property for him.[30] . . . . In the absence of proof to the contrary, a parent will be assumed to have the legal right to the earnings of the minor and must include them in his return. (Art. 403.)

The latter part of the article which holds that a parent will be assumed to have the legal right to the earnings of his minor child is reasonable, otherwise minor children with taxable incomes might erroneously assume that they were not individually responsible for making returns and the parent in turn might assume that, since the minor had a taxable income, the latter was responsible for the making of a return.

WHAT IS "EMANCIPATION."—In the second paragraph of the following recent ruling the Treasury for the first time attempts a general explanation of what constitutes emancipation from a parent.

RULING. The taxpayer states that his minor son had been emancipated, and by way of proof of such emancipation states that the son left the home of the father without parental consent and lived apart from the father and the home during 11 months of the taxable year 1918. During this period the parent made no effort to have the son return to the home and had no benefit of his earnings, which earnings were expended solely by the son for his own maintenance and benefit. The son did, however, return home in December, 1918, and was temporarily living at home at the close of the taxable year 1918, although he did not during this period contribute in any manner to the expense of the household, nor were his earnings turned over to the father. Inquiry is made as to whether these facts constituted an

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[28] [Former Procedure] Under the 1916 and 1917 laws, the returns of minors were filed by their guardians (Reg. 33, 1918, Art. 27). The words "of lawful age" are omitted from section 223 of the 1918 law, requiring returns of "every individual," etc.

[29] See page 92.

[30] See article 422.

emancipation of the son, and whether the son should have filed a return for 1918, during which year his earnings amounted to over $1,000.

It seems that in most jurisdictions emancipation need not be evidenced by any formal act. It may be expressed or implied, general or limited, in writing or oral. If a son supports himself and pays his board at home there is an implied emancipation, as is also the case if a parent allows his child to carry on a business for himself and exercises no control over his earnings. When a parent has either lost or relinquished his right to his child's earnings, such earnings belong to the child, who may assert his right thereto even as against the parent himself.

In New York, it appears, the law is very liberal with respect to the rights of children and their earnings even as against their parents. There it has been held that the intention of a parent to emancipate his child, or to consent to the child receiving his own earnings, may be inferred from circumstances indicating such intention; also that a parent's right to his child's earnings is relinquished when he makes no objection to a contract made by the child for his services on his own account.

It is therefore held that the facts stated in the present case disclose an emancipation of the taxpayer's son, under the laws of New York, which made it unnecessary for the taxpayer to include in his return for 1918 the earnings of the son for that year. Inasmuch as the son appears to have earned over $1,000 in 1918, a return should be filed by him for that year and tax paid thereon, if the return discloses any tax due. (C. B. I-1, page 238; I. T. 1216.)

Returns by soldiers and sailors.—

REGULATION. . . . . persons in the military or naval service of the United States, may file their returns of income with the collector at Baltimore. (Art. 447.)[31]

They may, if they prefer, file them in the district in which they have a legal residence.

Returns by fiduciaries.—The law[32] classes fiduciaries as individuals in so far as returns are concerned. See Chapter XLII.

Income from partnerships included in individual returns of partners.—The individual returns of partners must include

[31] For verification of such returns, see page 95.
[32] Section 225.

the entire distributive shares of the partnership income credited to such partners "for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partners' net income is computed."[33] For the determination of the amounts of these distributive shares, see Chapter XXIX. For the application of the rates in cases where the partnerships' accounting periods are fiscal years during which different rates of tax are in effect, see Chapter XXIX. Partnerships are defined and distinguished from corporations in Chapter I.

Annual Returns by Partnerships[34]

Partnerships pay no income taxes as entities, but the partners are individually taxable on their distributive shares. Nevertheless, every partnership must, under the 1921 law[35] file an annual return giving the data necessary for the determination of the distributive shares.

Law. Section 224. **That every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.**[36]

The return should be made on form 1065.

Regulations. Partnerships as such are not subject to taxation

[33] Section 218 (a).

[34] **[Former Procedure]** Before their disappearance as a separate class for tax purposes, as of December 31, 1921, personal service corporations were required to file information returns similar to those of partnerships. For regulations and comments thereon, see *Income Tax Procedure*, 1922, pages 818-823.

[35] **[Former Procedure]** Before 1918 partnerships were required to file returns only upon special request of the Commissioner or collector. (Reg. 33, 1918, Art. 30.) Such requests were made in 1914, but none subsequently except that under the 1917 law returns were required from all partnerships as a basis for the assessment of excess profits tax. (Section 211.) The 1918 law required information returns.

[36] **[Former Procedure]** Under certain conditions a partnership reorganizing as a corporation before March 23, 1922, was permitted to make a return as a corporation back to January 1, 1921. See section 229.

under the statute but are required to make returns of income. . . . . (Art. 331.)

The return of a partnership shall state specifically (*a*) the items of its gross income enumerated in section 213 of the statute; (*b*) the deductions enumerated in section 214, other than the deduction provided in paragraph (11) of subdivision (a) of that section; (*c*) the amounts specified in subdivisions (a) and (b) of section 216 received by the partnership; (*d*) the amount of any income, war profits and excess profits taxes of the partnership paid during the taxable year to a foreign country or to any possession of the United States, and the amount of any such taxes accrued but not paid during the taxable year; (*e*) the names and addresses of the individuals who would be entitled to share in the net income of the partnership if distributed; (*f*) the amount of the distributive share of such net income of each such individual; and (*g*) such other facts as are required by form 1065. . . . . (Art. 412.)

Changes in partnership during taxable year.—There are many changes in partnership relations which do not involve dissolution of an existing partnership. When changes occur during a fiscal year, because of the death or withdrawal of a partner or the admission of a new partner, and when the partnership continues except as to the changes mentioned, no good purpose would seem to be served by making returns until the end of the taxable year.

Regulation. . . . . Whenever a new partner is admitted to a partnership, or any existing partnership is reorganized, the facts as to such change or reorganization should be fully set forth in the next return of income, in order that the Commissioner may determine whether any gain or loss has been realized by any partner. . . . . (Art. 1570.)

The reference to the "next return" would not indicate that an immediate or special return was required. In any event every partnership return is merely an "information" return and is useful only after the returns on which it is a check are filed.

Return by receiver of partnership.—Article 424 of Regulations 62 provides that "a receiver in charge of the business of a partnership shall render a return on form 1065." This

also is in the form of a return of information and is not a return on which the tax is directly assessed. It, however, indicates the distributive profits or losses of the partners during the period covered by the receivership. When a receiver is appointed for a partnership the same person is usually made receiver for each of the partners.

Annual Returns by Corporations

What corporations must make returns.—Corporations[37] which are specifically exempt under the law[38] need make no annual return but must establish the fact of their exemption.[39] All other corporations must file returns, regardless of the amount of their net income.

LAW. Section 239. **(a) That every corporation subject to taxation under this title and every personal service corporation shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title. . . . .**

Corporations are required to file returns for their accounting periods, in the same manner as are individuals.[40] They may not close their books on a fiscal year basis and report on a calendar year basis.

Return sworn to by two officials.—

LAW. Section 239. **(a) . . . . The return shall be sworn to by the president, vice president, or other principal officer and by the trasurer or assistant treasurer. . . . .**

When only one officer is available, the officer signing the return may sign for the other in the latter's official capacity.[41]

Returns of incomplete and inactive corporations.—In the language of section 239, "every corporation *subject to taxation*

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[37] For a definition of "corporation", see page 40.
[38] See Chapter III.
[39] See page 61.
[40] See page 76 *et seq.*
[41] C. B. 4, page 307; O. D. 911.

under this title"[42] must make a return.[43] Consequently all corporations, no matter how small the income or whether or not they have any income at all, provided only that as corporations they are subject to the tax, must file returns. Such corporations, if in existence during any part of the year, are liable and must report from the first of the year to the date of dissolution or liquidation, or from the date of incorporation to the end of the taxable year.

REGULATION. . . . . A corporation having an existence during any portion of a taxable year is required to make a return. A corporation which has received a charter, but has never perfected its organization, and which has transacted no business and had no income from any source, may upon presentation of the facts to the collector be relieved from the necessity of making a return so long as it remains in an unorganized condition. In the absence of a proper showing to the collector such a corporation will be required to make a return. A corporation which was dissolved in 1921 prior to the enactment of the present statute is not relieved from the necessity of rendering returns thereunder for such portion of 1921 as elapsed before its dissolution. . . . . (Art. 621.)

The general rule is that, "so long as it has the right to function as a corporation under the laws of the State in which it was incorporated, regardless of whether or not it received any income during the period for which the return is rendered," a return must be made.[44]

It has been held that a return must be filed although the organization as a corporation has not been completed;[45] that where a single stockholder acquires all the stock and continues the business, the corporation is not thereby dissolved;[46] and that where after expiration of the charter by limitation, its business is continued in the corporate form.[47] A stockholder

[42] "And every personal service corporation"; such corporations are not tax-exempt after 1921.

[43] Section 13 (b) of the 1917 law reads, "every corporation not specifically enumerated as exempt shall make return of annual net income whether or not it may have for the particular year any net income."

[44] C. B. 4, page 307; O. D. 882.

[45] C. B. 1, page 233; S. 972. But see also Art. 621.

[46] C. B. 4, page 302; Sol. Op. 91.

[47] C. B. 4, page 305; Sol. Op. 93.

purchased the business of a corporation, operated the same as an individual, filed a "change of attitude" with the Secretary of State in Michigan. A return was required because it was held that the corporation was not dissolved but its powers merely suspended.[48]

Where a partnership business was incorporated, but the business was always carried on as a partnership, it was held that no corporation existed.[49]

Failure to present the facts to the collector as to the unorganized condition of a corporation was construed as a waiver of the privilege of not filing a return.[50]

As was pointed out in Solicitor's Opinion 91, the question whether a corporation has been properly organized or not is a question which cannot be raised collaterally; in other words, "the business was carried on in such a way as to render the incorporators liable in their corporate capacity."

When a change is made from the corporate form to single proprietorship or partnership, the corporation is not always formally dissolved. Care should be taken in such cases to observe all legal requirements, or the Treasury may require corporation returns to be made, even though entries have been made on the books transferring the assets. This remark is particularly applicable to those closely held corporations in which there is laxity in the holding of stockholders' meetings and proper authorization of the acts of the officers.

In general, if the business is continued under the corporate form, the Treasury takes the position that such an organization, if not a corporation *de jure* or *de facto*, is an association.[51]

It should be noted that article 621, quoted above, states that under specified circumstances an incomplete corporation may be excused from filing a return if a proper statement of the facts is made. Such a statement of facts must, however,

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[48] C. B. 4, page 308; O. D. 919.
[49] C. B. 5, page 232; O. D. 1078.
[50] C. B. 5, page 233; O. D. 1120.
[51] C. B. 4, page 305; Sol. Op. 93.

be made before the last due date[52] of the return for the period under consideration.[53]

Some confusion exists in the rulings regarding the precise point of time at which liability for making returns commences.

A corporation secured its charter in October. It had been intended that the corporation begin business on the preceding May 1. Stock was sold with the understanding that the profits applicable thereto dated from May 1. The corporation actually took over the assets as of May 1. It was held that the corporation was not in existence nor did it receive income prior to October.[54] The ruling is technically correct, but runs counter to recognized business practice. The partnership ended in fact, if not in law, on April 30, and no report of profits thereafter could be made by the partnership.

The ruling is not entirely consistent with the position taken by the Treasury in those cases where it was held that a return must be made as a corporation even though the corporate organization has not been completed. In another case the Treasury held that the taxable period of the corporation began as of the date of the issuance of the certificate by the Secretary of State.[55]

Ruling. In accordance with the terms of a contract between the O Corporation and the M Corporation, the assets and liabilities of the O Corporation were transferred to the M Corporation on December 31, 1919, and the M Corporation was to have the income received by the O Corporation between October 4, 1919, and December 31, 1919, the end of its taxable year.

Held, that each corporation is required to render a return for its full taxable year and that the O Corporation must include in its return the entire income received in 1919, including any gain realized from the sale of its assets to the M Corporation. (C. B. 5, page 231; Digest O. D. 1025.)

It is proper that returns should cover the full period during which both corporations were in existence; but the ruling

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[52] See page 68.
[53] C. B. 5, page 233; O. D. 1120.
[54] C. B. 5, page 231; O. D. 1016.
[55] C. B. 5, page 233; O. D. 1121.

should have stated that the O corporation could claim as an allowable deduction the income turned over after October 4 to the M corporation. The net income after October 4 was taxable income only to the corporation which retained it.

It is of interest to note that the Treasury has instructed the collectors that the specific penalty will not be asserted in cases where the corporation's return is late because it has not completed its organization. See Chapter VIII.

Return by new corporation.—In making a first return a corporation simply makes return on the basis of its fiscal year.[56] No notice to the Commissioner of the date of the close of the fiscal year is required from a new corporation.[57]

Holding companies with income only from dividends must make returns.—Section 239, quoted on page 106, appears to include holding companies receiving no income other than dividends from subsidiaries. Dividends received by a corporation must be reported as gross income [section 233 (a) and section 213] even though they are deducted in order to ascertain net income. If any doubt arises concerning the liability of holding companies to submit returns, the Commissioner will unquestionably require such returns under section 1307 which empowers him to demand returns whenever in his judgment he considers them "necessary."[58]

Return of foreign corporation filed by agent.—

LAW. Section 239. **(a) . . . . If any foreign corporation has**

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[56] **[Former Procedure]** Section 226 of the 1918 law provided: "If a taxpayer making his first return for income tax keeps his accounts on the basis of a fiscal year he shall make a separate return for the period between the beginning of the calendar year in which such fiscal year ends and the end of such fiscal year."

In answer to an inquiry as to the method of reporting used by a corporation which organized on October 1, 1918, and wished to establish September 30, 1919, as its first fiscal period, Commissioner Roper on March 12, 1919, gave an interpretation which obviated any necessity for reporting a fractional part of the year when a new corporation did not wish to do so

[57] See page 76.

[58] See page 67.

no office or place of business in the United States but has an agent in the United States, the return shall be made by the agent. . . . .

Regulation. Every foreign corporation[59] and corporation satisfying the conditions set forth under section 262, having income from sources within the United States, must make a return of income on Form 1120. If such a corporation has no office or place of business here, but has a resident agent, he shall make the return. It is not necessary, however, for it to be required to make a return that the foreign corporation shall be engaged in business in this country or that it have any office, branch, or agency in the United States. . . . (Art. 625.)

Foreign corporations are treated in detail in Chapter XLI.

Returns of insurance companies.—The 1921 law[60] provides for taxation of life insurance companies on the basis of investment income only. Beginning with 1922, insurance companies[61] (other than life or mutual insurance companies) make special returns in lieu of the ordinary income and capital stock tax returns. For detailed discussion, see Chapter XLIII.

Returns by receivers, trustees in bankruptcy or assignees.—

Law. Section 239. (a) . . . . In cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.

Regulation. When a corporation is dissolved, its affairs are usually wound up by a receiver or trustees in dissolution. The corporate existence is continued for the purpose of liquidating the assets and paying the debts, and such receiver or trustees stand in the stead of the corporation for such purposes. Any sales of property by them are to be treated as if made by the corporation for the purpose of ascertaining the gain or loss. No gain or loss is realized by a corporation from the mere distribution of its assets in kind upon dissolution,

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[59] For special provisions applying to foreign life insurance companies, see Chapter XLIII.

[60] Section 243.

[61] Section 246.

however they may have appreciated or depreciated in value since their acquisition. . . . . (Art. 548.)

Returns were required to be filed by the trustees in liquidation of a Wisconsin corporation which had sold its assets.[62]

RETURNS BY RECEIVERS.[63]—The Treasury has held that receivers in certain proceedings are required to make returns. The regulations definitely specify that receivers in partition and similar proceedings are not required to render returns of income.

REGULATIONS. A receiver who stands in the stead of an individual or corporation must render a return of income and pay the tax for his trust, but a receiver of only part of the property of an individual or corporation need not. If the receiver acts for an individual the return shall be on form 1040 or 1040A. When acting for a corporation a receiver is not treated as a fiduciary, and in such a case the return shall be made as if by the corporation itself. . . . . A receiver in charge of the business of a partnership shall render a return on form 1065. A receiver of the rents and profits appointed to hold and operate a mortgaged parcel of real estate, but not in control of all the property or business of the mortgagor, and a receiver in partition proceedings, are not required to render returns of income. In general, statutory receivers and common law receivers of all the property or business of an individual or corporation must make returns. . . . . (Art. 424.)

Receivers, trustees in dissolution, trustees in bankruptcy, and assignees, operating the property or business of corporations, must make returns of income for such corporations on form 1120, covering each year or part of a year during which they are in control. Notwithstanding that the powers and functions of a corporation are suspended and that the property and business are for the time being in the custody of the receiver, trustee or assignee, subject to the order of the court, such receiver, trustee or assignee stands in the place of the corporate officers and is required to perform all the duties and assume all the liabilities which would devolve upon the officers of the corporation were they in control. A receiver in

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[62] C. B. 4, page 279; O. D. 821.

[63] [Former Procedure]

RULING. The net income of a corporation in the hands of a receiver who is acting solely as an officer of the court which appointed him and subject to its orders is not taxable under the act of October 3, 1913. This ruling does not apply to the net income of a corporation in the hands of trustees or voluntary liquidators not so acting. (C. B. 2, page 222; O. 1009.)

charge of only part of the property of a corporation, however, as a receiver in mortgage foreclosure proceedings involving merely a small portion of its property, need not make a return of income. . . . . (Art. 622.)

Liquidating agents of a national bank are required to make returns for each year they are in control. Liability for any additional taxes follows the assets into the hands of the stockholders.[64]

A receiver, when relieved of his trust by the resumption of the corporation as a going concern with possession of its physical property restored to it, is also relieved of making a return for the fiscal period during which such action took place.[65]

The Treasury has ruled that when trustees in liquidation are appointed for a corporation during a fiscal period, they should file a return for the whole of such fiscal period.[66]

The responsibility of filing a return rests with the receiver only when he is in fact operating the business as a business and not merely winding up its affairs.[67]

Depositors of a bank that has become insolvent, are made preferred creditors over the Commissioner of Internal Revenue.[68]

In a recent ruling, in a case where trustees in dissolution of a New York corporation objected to filing returns under article 622, the Treasury held that inasmuch as under the New York law (sections 35 and 221 of the General Corporation Law) a corporation was continued in existence for the purpose of winding up its business, the officers of the corporation rather than the trustees in dissolution, should make return.[69]

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[64] C. B. 4, page 308; O. D. 883.
[65] C. B. 4, page 308; O. D. 873.
[66] C. B. 4, page 309; O. D. 884.
[67] *Ibid.*
[68] C. B. 5, page 233; O. D. 990.
[69] I-38-514; A. R. R. 1115.

RETURN BY TRUSTEE IN BANKRUPTCY.—

RULING. A "trustee in bankruptcy" is required to file a return of net income for the bankrupt's estate if the net income exceeds the specific exemption of $1,000.

The bankrupt individual is required to file a return accounting for his individual earnings but is entitled to the exemptions provided in section 216 of the Revenue Act of 1918. (C. B. 1, page 175; O. D. 174.)

Return of earnings allocated to distributions.—

LAW. Section 239. . . . . **(c) There shall be included in the return or appended thereto a statement of such facts as will enable the Commissioner to determine the portion of the earnings or profits of the corporation (including gains, profits and income not taxed) accumulated during the taxable year for which the return is made, which have been distributed or ordered to be distributed, respectively, to its stockholders or members during such year.**

The general rule is that dividends are deemed to be paid from the "most recently accumulated earnings or profits,"[70] and the above requirement will more readily enable the Treasury to make the proper allocation.[71] What is desired is the amount of each dividend only, not the names of stockholders to whom they are payable. The Treasury has been sending out to taxpayers a form of surplus and profit and loss analysis, calling for the above information.

Returns of dividends paid.—In addition to the annual returns described above, section 254 requires corporations, when directed by the Commissioner, to file statements of dividends paid. See Chapter XIII.

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[70] Section 201 (b).

[71] For discussion of how the allocation should be made, see Chapter XXVII.

CHAPTER VI

RETURNS—AFFILIATED CORPORATIONS

General

For 1922 and subsequent years, affiliated corporations may, at their option, file either a consolidated return, or a separate return for each corporation. However, once the option is exercised, returns must be made on the same basis thereafter, unless permission to change the basis is obtained from the Commissioner. This option is in contrast with the procedure in the excess profits tax years, 1917 to 1921, when affiliated corporations were required to file consolidated returns in order to prevent shifting of profits or losses.

LAW. Section 240. (a) That corporations which are affiliated within the meaning of this section may, for any taxable year beginning on or after January 1, 1922, make separate returns or, under regulations prescribed by the Commissioner with the approval of the Secretary, make a consolidated return of net income for the purpose of this title, in which case the taxes thereunder shall be computed and determined upon the basis of such return. If return is made on either of such bases, all returns thereafter made shall be upon the same basis unless permission to change the basis is granted by the Commissioner.

If consolidated returns are made, intercompany transactions which involve profits or losses can be freely made without affecting the net taxable income. In addition to this, two important points should be considered in deciding how the option may be most advantageously exercised: (a) losses of affiliated companies and (b) loss of specific credits.

(a) The loss sustained by an affiliated company included in a consolidated return is applied against the net income of the other member or members of the group, thereby reducing the net taxable income. It is true that if a consolidated return is not rendered, the taxpayer may, under certain condi-

tions prescribed in section 204,[1] deduct losses sustained in one year from the net income of the succeeding year or years. However, a consolidation makes it possible to apply a loss against any net income in the *current year*. Since corporation earnings and losses do not run consistently from year to year, and since one corporation may lose year after year, it seems that consolidated returns are desirable.

(b) The question of the specific credit also has a direct bearing on the advisability of consolidation.

LAW. Section 236. **(b) In the case of a domestic corporation the net income of which is $25,000 or less, a specific credit of $2,000; but if the net income is more than $25,000 the tax imposed by section 230 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000; and . . . .**

A consolidation is entitled to but one specific credit of

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[1] **[Former Procedure]** No provision whatever for consolidated returns, either of corporations or partnerships, appeared in either the 1913 or 1916 laws. In the administration of the 1917 law, the Treasury permitted consolidated returns by corporations for excess profits purposes but not for income tax purposes. No specific provision in the 1917 law required the filing of consolidated returns; but by regulation (Reg. 41, Arts. 77 and 78) the Treasury, under the general provision of section 201, required the filing of consolidated returns for excess profits tax in the case of corporations, when there was either substantial stock ownership, or close financial relationship or control. Partnerships, which in 1917 were subject to excess profits tax, were, under the original 1917 regulations, neither required nor permitted to make consolidated returns. In a specific case the Treasury refused to accept a consolidated return where a partnership was affiliated with a corporation.

Articles 77 and 78 of Regulations 41 were amended by T. D. 3389 (I-37-508; August 24, 1922) to include partnerships in consolidations. This is in accord with section 1331 of the 1921 law which was passed to validate the requirement of consolidated returns under the 1917 law.

LAW. Section 1331. (a) That Title II of the Revenue Act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporations and domestic partnerships that were affiliated during the calendar year 1917.

Under previous *income* tax laws, prior to 1918, every corporation was held to be "a separate and distinct entity" and the tax was imposed upon each separately. If the subsidiary corporations had merely a nominal existence, however, being integral parts of the parent corporation, they were held not to be separately taxable (Reg. 33, 1918, Art. 208).

Under the 1918 law, consolidated returns were required for both income and profits taxes. See *Excess Profits Tax Procedure*, 1921, Chapter XIV. The 1918 law neither permitted nor required partnerships to make consolidated returns with corporations.

$2,000,[2] whereas, if separate returns are rendered, each corporation in the group having a net income of less than $25,000 may claim a specific credit of $2,000, which, taxed at 12½ per cent, means a saving of $250 per corporation.

The fact that affiliated companies are in the hands of receivers cannot exclude them from consolidation (C. B. I-1, page 296; A. R. R. 818).

The framers of the 1921 law evidently thought that the option of rendering separate returns opens the possibility of evasion of taxation by intercompany manipulations. For this or for some other reason, a provision has been inserted which empowers the Commissioner to make consolidated returns for certain enterprises.

LAW. Section 240. . . . . (d) . . . . *Provided*, That in any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses.

REGULATION. Subdivision (d) of section 240 provides that in any case of two or more related trades or businesses (whether incorporated or not, and whether organized in the United States or not), owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades or businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses. This provision relates not to the *payment* of taxes, but to the determination of the true income of related trades or businesses and thus indirectly to the *amount* of taxes which may be due under Title II and Title III of the statute. (Art. 637.)

It is unfortunate that the foregoing provision of the law appears at the end and as a part of a paragraph which deals with corporations entitled to the benefits of section 262.[3] Taxpayers might infer that the power granted to the Commissioner

[2] Section 240 (b).
[3] Section 262 deals solely with citizens and domestic corporations operating in possessions of the United States. See Chapter XLI.

is limited to corporations embraced in section 262. A careful analysis of this provision demonstrates that it cannot so apply because it contains the stipulation "whether organized in the United States or not," which cannot apply to a corporation qualifying under section 262. The power evidently is granted to the Commissioner in order to determine the true income, whether or not the businesses are affiliated within the meaning of section 240.

The power given to the Commissioner to consolidate accounts for the express purpose of ascertaining the true net income of affiliated interests, applies to any form of business, whether individual, partnership, or corporation.

It may be expected that the Commissioner will exercise his power in those cases where the income or deductions are illegally shifted. If minority interests are not affected, there is nothing illegal or immoral in shifting profits or losses in order to bring about an equitable tax burden.

To sum up, taxpayers may render either consolidated or separate returns, as they elect; but their right to render separate returns may be challenged by the Commissioner.

Conditions Precedent to Consolidated Returns

In order to file consolidated returns, the corporations involved must first meet the requirements of affiliation set forth in the law.

"Affiliated corporation" defined.—

LAW. Section 240. . . . . (c) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests. . . . .

There are cases in which consolidated returns are prohibited by the law itself or in which the circumstances may prevent the filing of consolidated returns.

Foreign corporations excluded.—

Regulation. . . . . Foreign corporations and corporations entitled to the benefits of section 262 may not file consolidated returns; . . . . (Art. 632.)

Ruling. Receipt is acknowledged of your letter dated April 11, 1919, in which you state: "A client of mine, a New Jersey corporation, owns all of the outstanding stock in a foreign corporation, which in turn owns all of the outstanding stock in a New York corporation. Although under article 636 of Regulations 45 relating to the income tax a domestic corporation is not required or permitted to file a consolidated return with a foreign corporation, it seems to me that the New Jersey and New York corporations above mentioned are affiliated as that term is defined in article 633, and that, on that account the New Jersey corporation should file a consolidated return for both, under the provisions of section 240 of the Revenue Act. . . . ."

In reply you are advised that in accordance with section 240 of the Revenue Act of 1918 it will be necessary for the New Jersey corporation and the New York corporation above mentioned to file a consolidated return, excluding the foreign corporation. (Letter to a subscriber of The Corporation Trust Company, signed by Acting Deputy Commissioner P. S. Talbert, and dated April 23, 1919.)

Corporations classed under section 262 excluded.—Domestic corporations which derive the major portion of their income from sources within the territorial possessions of the United States are, under the provisions of section 262 of the 1921 law, treated as foreign corporations and cannot be included in a consolidated return, by the taxpayer, although the Commissioner may consolidate the returns to ascertain the true income.[4] Where equity demands consolidation, taxpayers should request the Commissioner to exercise his discretion to require consolidated returns.

Law. Section 240. . . . . **(d) For the purposes of this section a corporation entitled to the benefits of Section 262 shall be treated as a foreign corporation: . . . .**

Corporations organized under China Trade Act, 1922, excluded.—Section 24 of the China Trade Act prevents the inclusion of corporations organized under its provisions in a

[4] Section 240 (d).

consolidated return. The 1921 law is amended by adding the following sentence to section 240:

LAW. Section 240. **(c) . . . . A corporation organized under the China Trade Act, 1922, shall not be deemed to be affiliated with any other corporation within the meaning of this section.**

Consolidated returns include only corporations.—In theory, consolidated returns should be permitted whenever business relations are so close that a shifting of income or expenses could be resorted to in order to save or equalize tax. However, with individuals and corporations being subject to different rates of tax, it is obvious that an individual trader, or a partnership, no matter how closely related to a corporation (even to the extent of 100 per cent joint ownership) cannot file consolidated returns.

RULING. A partnership owned all the stock of a corporation. The corporation sustained a loss for each of the years 1915 to 1919 inclusive. The partnership and corporation being separate entities it was held that the partnership may not reduce its income by transferring partnership funds for the purpose of liquidating the loss of the corporation.

Furthermore there is no provision in the Revenue Act of 1918 under which the partnership and the corporation may render consolidated returns. (C. B. 4, page 155; O. D. 795.)

Commercial or financial relationship (other than stock ownership) does not warrant consolidated returns.—It has been held that commercial or financial relations alone would not be sufficient ground to warrant a consolidated return. In this respect the 1918 and 1921 regulations differ from those of 1917.

RULING. . . . . Where only commercial or financial relations exist between corporations and there is no stock ownership or control of the character prescribed in the statute they may not be classed as affiliated corporations. (C. B. 2, page 225; Digest A. R. R. 123.)

"Substantially all the stock."—The phrase "substantially all the stock" is interpreted by the Treasury in the following regulation:

Regulation. . . . . The words "substantially all the stock" can not be interpreted as meaning any particular percentage, but must be construed according to the facts of the particular case. The owning or controlling of 95 per cent or more of the outstanding voting capital stock (not including stock in the treasury) at the beginning of and during the taxable year will be deemed to constitute an affiliation within the meaning of the statute. Consolidated returns may, however, be required for any taxable year beginning prior to January 1, 1922, even though the stock ownership is less than 95 per cent. When the stock ownership or control is less than 95 per cent, but in excess of 70 per cent, a full disclosure of the affiliations should be made showing all pertinent facts, including the stock owned or controlled in each subsidiary or affiliated corporation and the percentage of such stock owned or controlled to the total stock outstanding. This information will also be required where like conditions exist and the taxpayer elects to file a consolidated return for any taxable period beginning on or after January 1, 1922. Such statement should preferably be made in advance of filing the return, but if a consolidated return is filed subject to the approval of the Commissioner, the required statement should be filed as a part of the return. . . . . (Art. 633.)

It should be noted that when the stock ownership is between 70 and 95 per cent a disclosure of affiliation must be made on form 819. After this form has been filed once it need not be filed again unless a change occurs in the stock ownership.

The following rulings, which deny permission to consolidate, are illustrative of the Treasury's interpretation of the phrase "substantially all the stock" in cases where there is less than 95 per cent stock control without substantial intercompany transactions.

Rulings. Held, that where 19 per cent of the stock of a corporation is owned by minority interests, 13 per cent of which is owned unconditionally by one of the officers, and where 39 per cent of the stock of another corporation is held by minority interests, 10 per cent of which is held unconditionally by a different officer, and in each instance the officer has no other interest in the otherwise controlled corporations, there should be no consolidation in the years 1917, 1918, and 1919 for tax purposes. (C. B. 4, page 309; Digest A. R. R. 378.)

Held, that stock control of 69.04 per cent in the year 1918, without intercompany operating transactions or artificial intercorporate re-

lationship, is insufficient to authorize a consolidated tax return for that year. (C. B. 4, page 414; Digest A. R. R. 448.)

The last quoted ruling intimates that: (1) if the companies had been operated as one business enterprise, and (2) if profits could have been shifted, a consolidated return should have been made. This is sound.

The author is of the opinion that the Treasury has given too much weight to the size of the minority interest. A 5 per cent minority has the same rights as a 30 or 40 per cent minority. The primary tests are: (1) Have the companies been operated as one enterprise? (2) Could the profits have been shifted to any material extent?

In another case a corporation owned all of the stock of a subsidiary, but deposited all of such stock with a trust company as collateral to cover the issue of its preferred stock. It retained, during the period of the agreement, no control therein. A consolidation of the parent and subsidiary company was denied.[5]

Interpretation of the phrase "the same interests."—In its regulation the Treasury requires that each interest shall hold substantially the same percentage of stock in each corporation to constitute affiliation.

REGULATION. . . . . The words "the same interests" shall be deemed to mean the same individual, partnership, or corporation, or the same individuals, partnerships, or corporations, but when the stock of two or more corporations is owned or controlled by two or more individuals, by two or more partnerships, or by two or more corporations, the corporations will not be held to be affiliated unless the percentage of stock of such corporations held by each individual, each partnership, or each corporation is substantially the same in each of the corporations. (Art. 633.)

Separate companies are sometimes the outgrowth of one business which has been divided in order to distribute an estate satisfactorily. Before the distribution three beneficiaries may jointly own three businesses, in which event the

[5] C. B. 5, page 235; A. R. R. 641.

law calls for a consolidated return. After the distribution the same interests own precisely the same assets. Conditions do not permit that each business be divided into three equal parts; therefore the proportions—not the same interests—change. If the change inadvertently results in an inequitable tax, a consolidated return should be permitted or relief should be granted to the corporation which suffers unduly.

Rulings. It appears that there are two corporations, one owning and operating properties in the Hawaiian Islands and the other owning and leasing various pieces of property in California. The stock of the California corporation is held by the members of one family, four male members of the family each owning five-twenty-fourths and a sister one-sixth of the entire stock. The Hawaiian corporation is held by the same family principally, with the exception that one-sixth of the stock is held by each of the four male members aforementioned, one-sixth by the sister aforementioned, and one-sixth by the husband of a deceased sister to the other stockholders. The affairs and operations of the two corporations have in the past been, and are now being, actively conducted by and in the control of the male members of the family. The two corporations, it is stated, are in purpose and effect only one enterprise. In accordance with Regulations 45, where substantially all of the stock of two or more corporations is held by the same interests, such holdings must be in substantially the same proportions in order to require a consolidated return. It is therefore held that these corporations should file separate returns. (Letter to The Corporation Trust Company, signed by Commissioner Daniel C. Roper, and dated April 11, 1919.)

The application to make a consolidated return was denied in the case of two companies in one of which 24.26 per cent of the stock of the first company was owned by individuals who held no stock whatever in the second company, and more than 6 per cent of the stock of the second company was held by individuals who held no stock in the first company. Such a division of ownership can not be considered either under the statute or the regulations as a case in which substantially all of the stock of two or more corporations is owned or controlled by the same interests. (C. B. 1, page 236; Digest T. B. R. 52.)

It is very difficult to ascertain what was the Treasury's real basis for rejection in the above cases, particularly the former. If the stockholders of one corporation are identical with those of another, or nearly so, the author feels that the law intends

that consolidated returns may be filed and that regulations in conflict with this intent must eventually be modified. An effort must be made to get below the mere form of the combination to the actual facts of the relationship.

RULINGS. The interests of husband and wife in the State of Wisconsin are separate and distinct, and, in the absence of any ulterior motive, the holdings of husband and wife in two or more corporations should be treated as separate and independent interests for the purpose of determining whether corporations are affiliated. (C. B. I-1, page 298; Digest A. R. R. 942.)

The M corporation is engaged in the real estate brokerage business, deriving its income from commissions earned from the sales and rental of real estate. The O corporation was organized for the purpose of holding such parcels of real estate as A might from time to time acquire and during 1917 its income consisted of rents from houses owned. Since the organization of the two corporations the only intercompany transactions which have occurred are two small loans upon which the legal rate of interest was charged. A, the sole stockholder of the O corporation, owns 86 per cent of the stock of the M corporation, and 10 per cent of the stock of the latter corporation is owned by the secretary of the O corporation.

Held, that consolidated returns should be required for the years 1918 and 1919 in accordance with the requirements of section 240 of the Revenue Act of 1918 and that such returns should not be required for 1917 under the provisions of articles 77 and 78 of Regulations 41 and section 1331 of the Revenue Act of 1921. (C. B. I-1, page 413; Digest A. R. R. 855.)

It is noted that affiliation is allowed under the 1918 law in the second case quoted above, notwithstanding the minor nature of intercompany transactions. The control of 86 per cent governs. This would seem to be a fair interpretation of the law.

Affiliated corporations in hands of receivers not excluded.—

RULING. . . . . The basis of consolidation, therefore, for the years in question (1917, 1918, and 1919) is the ownership or control of the *stock* of the corporations. The appointment of a receiver for a corporation does not ordinarily change the control or ownership of the corporation's stock. While it may change the control of the corporation for the period of the receivership, the consolidation is not based upon control of the corporation but the ownership or control of

the corporation's stock. Where the appointment of a receiver leaves the ownership and control of the corporation's stock in the parent company, the plain language of the Acts and regulations requires the subsidiary to be consolidated with the parent company and there is no authority for excluding it from the consolidation during the period of the receivership. . . . . (C. B. I-1, page 296; A. R. R. 818.)

Unincorporated company using corporate assets without consideration, a branch of the corporation.—

Ruling. A corporation, the majority of whose stock is owned by its president and manager, turned over a branch of its business to a new company, not incorporated, the president and manager of the corporation retaining control of the new company. There was no transfer of corporate assets. The new company simply used the assets of the corporation without consideration of any kind but was operated as a separate and distinct enterprise. Held that the new company is merely a branch of the corporation and not a separate entity for Federal income tax purposes. Its income should be included in the return of the corporation and is subject to both income tax and excess profits tax. (C. B. 2, page 224; Digest O. D. 467.)

Partnerships becoming incorporated under section 229 included.—

Ruling. A partnership, upon becoming a corporation in accordance with the provisions of the law, and owning 99 per cent of the capital stock of three other corporations should file a consolidated return. (C. B. 1, page 307; Digest T. B. R. 27.)

The ruling is issued under the 1918 law. A partnership or individual business, which became incorporated between January 1, 1921, and March 23, 1922, has the option of being taxed as a corporation from the former date, in accordance with section 229[6] of the 1921 act. If affiliated with a corporation, it may be included in a consolidated return.

Corporations having "government contract" income may be included in consolidation for 1922.—Article 51 of Regulations 62 provides in part:

Such items as claims for compensation under canceled Govern-

[6] See Chapter XXIX.

ment contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined. (Art. 51.)

Section 240 (e) of the 1921 law reads:

LAW. Section 240. **(e) Corporations which are affiliated within the meaning of this section shall make consolidated returns for any taxable year beginning prior to January 1, 1922, in the same manner and subject to the same conditions as provided by the Revenue Act of 1918.**

Section 240 (a) of the 1918 law contained the following limitation on the filing of consolidated returns:

1918 LAW. Section 240. **(a) That corporations which are affiliated . . . . shall . . . . make a consolidated return . . . .** *Provided,* **That there shall be taken out of such consolidated net income and invested capital, the net income and invested capital of any such affiliated corporation organized after August 1, 1914, and not successor to a then existing business, 50 per centum or more of whose gross income consists of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive. In such case the corporation so taken out shall be separately assessed on the basis of its own invested capital and net income and the remainder of such affiliated group shall be assessed on the basis of the remaining consolidated invested capital and net income. . . .**

The foregoing limitation is not effective after 1921, so that a corporation having "government contract" income in 1922 in any amount may be included in a consolidated return.[7]

Effect of change of ownership, mergers, reorganizations and corporations with changed names.—The following regulation deals with the procedure in cases where changes in the affiliated status of corporations have taken place:

REGULATION. (*a*) Where corporations are affiliated at the beginning of a taxable year but due to a change in stock ownership or

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[7] **[Former Procedure]**
RULING. The income of affiliated corporations which is derived from Government contracts is taxable (except as provided in sec. 240(a) of the Revenue Act of 1918) upon the basis of the total sum received from that source by the group and not upon the basis of the separate amount received by each corporation. (Also Art. 635.) (C. B. 2, page 226; O. D. 415.)

control during the year the affiliated status is terminated, or (*b*) where corporations are not affiliated at the beginning of the taxable year but through change of stock ownership or control during the year become affiliated, a full disclosure of the circumstances of such changes of stock ownership shall be submitted to the Commissioner. Ordinarily in such cases the parent or principal company, under the conditions described in (*a*) above, should exclude from its return the income and invested capital of such subsidiary or subordinate company from the date of the change of stock ownership, and under the conditions described in (*b*) above, should include in its return the income and invested capital of such subsidiary or subordinate company from the date of the change of stock ownership. In either case the subsidiary or subordinate corporation whose status is changed during the taxable year should make a separate return for that part of the taxable year during which it was outside of the affiliated group.

Where, in accordance with the procedure set forth above, a return is made by a corporation for a period less than a year, the tax shall be computed in accordance with sections 226 and 239 and the articles thereunder. In any case in which the change of consolidated status is for a period so short as to be negligible, a consolidated return or separate returns for the entire period, as the case may be, may be filed; in such cases, however, there should accompany the return a complete statement setting forth the changes in the affiliated status occurring during the taxable year. (Art. 634.)

It may be necessary to file three or more returns for a single year in case of merger—one for each corporation before the merger, covering the portion of the year during which the corporations existed as separate entities, and one for the merged corporation after consolidation. When the change consists of the absorption of one company by another and the effect has been merely the enlargement of the absorbing corporation, only one return need be filed by the absorbing company, but a separate return is required from the absorbed company for the fractional period immediately antedating the merger. Generally speaking, it is not advantageous to file separate returns when consolidated returns may be filed.

In what are known as "seasonal" businesses, care should be taken to avoid making a change at a time of year when there may be a net loss for the period elapsed since the beginning of the fiscal year. Although, under the 1921 law,[8]

[8] Section 204.

a net loss may be carried forward and "deducted from the net income of *the* taxpayer for the succeeding year," such net loss could not be taken advantage of by a *successor* corporation.

The consolidation of net income.—The method of preparing the consolidated statement of net income is indicated in the following:

REGULATION. Subject to the provisions covering the determination of taxable net income of separate corporations, and subject further to the elimination of intercompany transactions (whether or not resulting in any profit or loss to the separate corporations), the consolidated taxable net income shall be the combined net income of the several corporations consolidated. Only one specific credit of $2,000, as provided in section 236 (b) and article 591, shall be allowed the consolidated group, and this only in case the net income of the group does not exceed $25,000; but if such net income is more than $25,000, the tax imposed by section 230 shall not exceed the tax which would be payable if the $2,000 were allowed, plus the amount of the net income in excess of $25,000. In respect of the statement of gross income and deductions and the several schedules required under Form 1120, a corporation filing a consolidated return is required to prepare and file such statements and schedules in columnar form to the end that the details of the items of gross income and deductions for each corporation included in the consolidation may be readily audited. (Art. 636.)

The subject of consolidated statements is fully discussed and illustrated in the author's *Excess Profits Tax Procedure,* 1921, Chapter XIII.

Specific credit in case of consolidated return.—

LAW. Section 240. **(b) . . . . There shall be allowed in computing the income tax only one specific credit computed as provided in subdivision (b) of section 236.**

Under the 1918 law one specific credit of $2,000 was allowed in computing the net income of a consolidation. In making consolidated returns for taxable years beginning on or after January 1, 1922, this specific credit will be permitted only if the net income of the consolidation does not exceed $25,000.

Liberty bond exemptions.—The tax exemptions arising from holdings of Liberty bonds are calculated by adding together the exemptions to which each corporation of the group would be entitled were it rendering a separate return.[9] This provision, adopted perhaps partly from motives of expediency, indicates one of the cases in which the consolidated total is not the deciding factor in the tax return.

Dividends guaranteed by holding company.—

Regulation. . . . . A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary. . . . . (Art. 582.)

Transfer of assets between affiliated companies not considered a replacement.—

Ruling. Where one of an affiliated group of corporations which files a consolidated return established a replacement fund in accordance with the provisions of Article 50, Regulations 45, the expenditure of the replacement fund so established to replace a steamship in kind is not a replacement within the meaning of that term, when the steamship acquired to replace the one lost was acquired from another of the affiliated corporations. (C. B. 5, page 94; Digest A. R. M. 142.)

In refusing to consider the purchase of assets of one affiliated company from another affiliated company in the same group as constituting a "replacement" as defined in articles 49 and 50, of Regulations 45, the Treasury is maintaining its contention that a group of affiliated companies must be considered as an integral whole.

Reconciliation of taxable income with book figures.—While some accountants advocate other methods, the author, as the result of his experience, is of opinion that the most satisfactory method of preparing that part of Schedule L relat-

[9] C. B. 1, page 87; T. B. R. 7.

ing to income, in the case of a consolidated return, is to compile a separate reconciliation for each corporation as if a separate return were to be filed for each, and then to combine these separate reconciliations, eliminating any intercompany adjustments. The result will be a reconciliation of the consolidated taxable income. The use of a similar method in preparing the reconciliation of consolidated surplus is advocated.

Consolidated Returns

Returns to be filed by affiliated corporations.—

Regulation. . . . . The consolidated return shall be filed on Form 1120 by the parent or principal reporting corporation in the office of the collector of the district in which it has its principal office. Each of the other affiliated corporations shall file in the office of the collector of its district Form 1122, along with the several schedules indicated thereon. The parent or principal corporation filing a consolidated return for the first time shall include in such return a statement setting forth, (*a*) the name and address of each of the subsidiary or affiliated corporations included in such return; (*b*) the par value of the total outstanding capital stock of each of such corporations at the beginning of the taxable year; (*c*) the par value of such capital stock held by the parent corporation or by the same interests at the beginning of the taxable year; (*d*) in the case of affiliated corporations, the stock of which is owned or controlled by the same interests, a list of the individuals, partnerships, or corporations constituting such interests, with the percentage of the total outstanding stock of each affiliated corporation held by each of such individuals, partnerships, or corporations during all or any part of the taxable year; and (*e*) a schedule showing the proportionate amount of the total tax which it is agreed among them is to be assessed upon each affiliated corporation. If there are substantial changes of ownership during the taxable year, the information required under (*b*) and (*c*) above should show the conditions existing immediately subsequent to such changes. . . . . (Art. 632.)

Taxable year when affiliated corporations have different fiscal years.—

Regulation. In the case of all consolidated returns for taxable years beginning prior to January 1, 1922, consolidated invested capital must be computed as of the beginning of the taxable year of the parent or principal reporting corporation and consolidated income

must be computed on the basis of its taxable year. If a consolidated return is made for any taxable year beginning on or after January 1, 1922, consolidated income must be computed on the basis of the taxable year of the parent or principal reporting corporation. Whenever the fiscal year of one or more subsidiary or other affiliated corporations differs from the fiscal year of the parent or principal corporation, the Commissioner should be fully advised by the taxpayer in order that provision may be made for assessing the tax in respect of the period prior to the beginning of the fiscal year of the parent or principal corporation. . . . . (Art. 638.)

Distribution of the tax between the affiliated corporations.[10]—

LAW. Section 240. **(b) In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each. . . . .**

After January 1, 1922, the tax is a flat rate of 12½ per cent on net income. Distribution of the tax on the basis of the net income assignable to each affiliated corporation, therefore, appears to be a fair method of allocation. It is, however, inequitable where net losses are incurred by some of the affiliated corporations. The profitable companies benefit collectively to the extent of 12½ per cent of the losses included in the consolidated group. It is suggested that the tax in such cases be apportioned on the basis of the tax each company would have to pay if reporting as a separate entity. In computing the tax payable by each company as a separate entity, any company which had in the previous year sustained a net loss would deduct the amount thereof from the current year's

[10] **[Former Procedure]**

RULING. In cases where corporations and partnerships are consolidated under the 1917 Act as amended by Section 1331 of the Revenue Act of 1921, the excess profits tax should be allocated to the partnerships as a group according to the invested capital and net income assignable to the partnership group. (C. B. I-1, page 295; Digest L. O. 1083.)

This ruling, however, does not prevent any other allocation of the tax among the units of the consolidation.

income. In this way a company which has a loss one year and a profit in the next, would in the allocation of the later year's consolidated tax, receive the benefit of offsetting the previous year's loss against the later year's profit. This method is entirely equitable as between the affiliated companies, provided the same rate of tax is in effect from year to year.

CHAPTER VII

PUBLICITY OF RETURNS AND DISCLOSURE OF INFORMATION

Returns are carefully guarded. Section 257 provides that they may be inspected by certain parties under closely prescribed conditions. Inspection must be made under rules and regulations prescribed by the Secretary of the Treasury and approved by the President.

LAW. Section 257. **That returns upon which the tax has been determined by the Commissioner shall constitute public records; but they shall be open to inspection only upon order of the President and under rules and regulations prescribed by the Secretary and approved by the President: . . . .**

The regulation, quoted in part below, has been promulgated with reference to inspection of returns filed under all the income tax laws since 1913.[1] It should be noted that a written application must be made to inspect a return.

REGULATION. The returns upon which the tax has been determined by the Commissioner, although public records, are open to inspection only to the extent authorized by the President, except as otherwise expressly provided. The President, by an executive order dated January 24, 1922, directed that returns of income should be subject to inspection in accordance with the following regulations prescribed by the Secretary of the Treasury:

1. These regulations deal only with *inspection* of returns, as the statutes expressly require the approval of the President of regulations on this subject. Other uses to which returns may be lawfully put, without action by the President, are not covered by these regulations.

2. . . . . The word "return" when so used shall, unless otherwise indicated, include income and profits tax returns; and also special excise tax returns of corporations filed pursuant to Section 1000, Title X, of each of the Revenue Acts of 1918 and 1921.

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[1] A similar provision of the 1909 law was declared constitutional. (*Flint v. Stone Tracy Co.*, 220 U. S. 107, 55 L. Ed. 389, 31 Sup. Ct. 342.) For the regulations under the 1913 and subsequent laws, see T. D. 2961 and 2962.

3. Written statements filed with the Commissioner of Internal Revenue designed to be supplemental to and to become a part of tax returns shall be subject to the same rules and regulations as to inspection as are the tax returns themselves.

4. Except as hereinafter specifically provided, the Commissioner of Internal Revenue may, in his discretion, upon written application setting forth fully the reasons for the request, grant permission for the inspection of returns in accordance with these regulations. The application will be considered by the Commisisoner and a decision reached by him whether the applicant has met the conditions imposed by these regulations and whether the reasons advanced for permission to inspect are sufficient to permit the inspection. Such written application is not required of the officers and employees of the Treasury Department whose official duties require inspection of a return, or of the Solicitor of Internal Revenue.

. . . .

13. When it becomes necessary for the Department to furnish returns or copies thereof for use in legal proceedings, inspection of such returns or copies that necessarily results from such use is permitted.

14. Except as provided in paragraph 13, returns may be inspected only in the office of the Commissioner of Internal Revenue, Washington, District of Columbia.

15. A person who, under these regulations, is permitted to inspect a return may make and take a copy thereof or a memorandum of data contained therein.

16. By section 3167 Revised Statutes, as amended by the Revenue Act of 1918, and reenacted without change in section 1311 of the Revenue Act of 1921, it is made a misdemeanor for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof, or source of income, profits, losses, or expenditures appearing in any income return, which misdemeanor is punishable by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court, and if the offender be an officer or employee of the United States, by dismissal from office or discharge from employment.

17. All former regulations bearing on the subject of inspection of returns are hereby superseded.

18. These regulations shall remain in force until expressly withdrawn or overruled. (Art. 1090.)

Who may secure copies of returns.—Persons or corporations desiring copies of their own returns may secure them. Representatives of taxpayers holding powers of attorney are

legally entitled to inspect or secure copies of their clients' returns. Access to corporation returns is permitted to stockholders and receivers as a right and to state officers under carefully restricted conditions.[2] Copies of returns are furnished the proper officers and employees of the Treasury, and to the proper officers of a court for use in a trial of any case to which both the United States and the person rendering the return are parties.[3] Otherwise returns are considered "inviolably confidential."[4]

REGULATION. . . . . 2. A copy of an income return may be furnished by the Commissioner of Internal Revenue to the person who made the return or to his duly constituted attorney, or if the person is deceased, to his executor or administrator; or if the entity is in the hands of a receiver, trustee in bankruptcy, guardian, or similar legal custodian, to the receiver, trustee, or other similar custodian upon written application for same, accompanied by satisfactory evidence that the applicant comes within this provision. "The person who made the return," as herein used, refers in the case of an individual return to the individual whose return is desired, and in the case of a return of a corporation, association, joint-stock company, insurance company, or fiduciary, to the corporation, association, joint-stock company, or fiduciary, a copy of whose return is desired. A corporation may also designate by proper action of its board of directors the officer or individual to whom a copy of a return made by the corporation may be furnished, and upon sufficient evidence of such action and of the identity of the officer or individual, a copy may be furnished to such person. A copy of a partnership income return will be furnished to the partners only in case all the partners join in the request therefor, it matters not what particular partner or officer of the partnership made the return. If the partnership has been dissolved, the members surviving may be furnished a copy if all the members surviving join in the request. (Art. 1091.)

It would appear, however, that under article 1090 (7) a single partner may inspect the partnership return and make a copy thereof, although he could not require the Commissioner to supply a copy.

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[2] See page 139.

[3] Art. 1091. See page 137.

[4] *Income Tax Primer,* 1918, question 142.

Inspection of individual returns.—

Regulation. . . . . 5. The return of an individual shall be open to inspection as follows:

(*a*) By the officers and employees of the Treasury Department whose official duties require such inspection and by the Solicitor of Internal Revenue; (*b*) by the person who made the return, or by his duly constituted attorney in fact; (*c*) by the administrator, executor, or trustee of the taxpayer's estate, or by the duly constituted attorney in fact of such administrator, executor, or trustee, where the maker of the return has died; and (*d*) in the discretion of the Commissioner of Internal Revenue, by one of the heirs at law or next of kin of such deceased person upon showing that he has a material interest which will be affected by information contained in the return.

6. A joint return of a husband and wife shall be open to inspection (*a*) by the officers and employees of the Treasury Department whose official duties require such inspection and by the Solicitor of Internal Revenue; and (*b*) by either spouse for whom the return was made (or his or her duly constituted attorney in fact or legal representative), upon satisfactory evidence of such relationship being furnished. . . . . (Art. 1090.)

It is well to note that not even the officers of a state imposing an income tax have been granted the right of access to individual returns.

Inspection of partnership returns.—

Regulation. . . . . 7. The return of a partnership shall be open to inspection (*a*) by the officers and employees of the Treasury Department whose official duties require such inspection and by the Solicitor of Internal Revenue; and (*b*) by any individual (or his duly constituted attorney in fact or legal representative) who was a member of such partnership during any part of the time covered by the return, upon satisfactory evidence of such fact being furnished. (Art. 1090.)

Inspection of returns of estates and trusts.—

Regulation. . . . . 8. The return of an estate shall be open to inspection (*a*) by the officers and employees of the Treasury Department whose official duties require such inspection, and by the Solicitor of Internal Revenue; (*b*) by the administrator, executor, or trustee of such estate, or by his duly constituted attorney in fact; and (*c*) by one of the heirs at law or next of kin of the deceased person whose estate is being administered upon a showing of a material interest which will be affected by information contained in the return.

9. The return of a trust upon which a tax has been determined shall be open to inspection (*a*) by the officers and employees of the Treasury Department whose official duties require such inspection, and by the Solicitor of Internal Revenue; (*b*) by the trustee or trustees, or the duly constituted attorney in fact of such trustee or trustees; and (*c*) by any individual (or his duly constituted attorney in fact or legal representative) who was a beneficiary under such trust during any part of the time covered by the return, upon satisfactory evidence of such fact being furnished. (Art. 1090.)

Rulings. An original letter with regard to his return written by a decedent to the collector may not be furnished to the attorneys for the estate. A certified or photostatic copy may, however, be given to them provided the executors submit a copy of the letters testamentary issued to them by the court, together with a letter signed by them authorizing the attorneys to receive a copy of the letter in question. (C. B. 3, page 313; O. D. 576.)

The executor of an estate may secure copies of income tax returns filed by the decedent upon submission to the Commissioner of a certified copy of letters testamentary evidencing his appointment as executor. (C. B. 1, page 265; O. D. 355.)

Inspection of corporation returns.—

Regulation. . . . . 10. The return of a corporation shall be open to inspection (*a*) by the officers and employees of the Treasury Department whose official duties require such inspection and by the Solicitor of Internal Revenue; (*b*) upon satisfactory evidence of identity and official position, by the president, vice-president, secretary or treasurer of such corporation, or, if none, its principal officer; and (*c*) by a stockholder of such corporation as provided in paragraph 11 hereof. (Art. 1090.)

Certified copies of returns for use as evidence.—

Regulation. 1. The original income return of an individual, partnership, corporation, association, joint-stock company, insurance company, or fiduciary, or a copy thereof, may be furnished by the Commissioner of Internal Revenue to a United States attorney for use as evidence before a United States grand jury or in litigation in any court, where the United States is interested in the result, or for use in the preparation for such litigation, or to an attorney connected with the Department of Justice designated to handle such matters, upon written request of the Attorney General, the Assistant to the Attorney General, or an Assistant Attorney General. When an income return or copy thereof is thus furnished, it must be limited in use to the purpose for which it is furnished and is under no conditions to be made public except where publicity necessarily results from

such use. In case the original return is necessary, it shall be placed in evidence by the Commissioner of Internal Revenue or by some other officer or employee of the Internal Revenue Bureau designated by the Commissioner for that purpose, and after it has been placed in evidence it shall be returned to the files in the office of the Commissioner in Washington. An original return will be furnished only in exceptional cases, and then only when it is made to appear that the ends of justice may otherwise be defeated. Neither the original nor a copy of an income return, desired for use in litigation in court where the United States Government is not interested in the result and where such use might result in making public the information contained therein, will be furnished, except as otherwise provided in the next succeeding paragraph.[5] (Art. 1091.)

Ruling. Ownership certificates are income returns within the meaning of section 3167, Revised Statutes, as amended. Since they are filed as a result of income tax laws for the purpose of being used in connection with income tax returns they are to be treated as such under the regulations governing the furnishing of copies. . . . . (C. B. 1, page 262; O. 879.)

A collector of internal revenue cannot be compelled to produce in court tax reports made to him and a regulation forbidding him to disclose such information is not unconstitutional (*Boske v. Comingore,* 177 U. S. 459). A statute which authorizes the district attorney to request a taxpayer to produce his private papers in court, failing which the government's contention shall be taken as confessed, is unconstitutional as an "unreasonable search and seizure" (*Boyd v. U. S.,* 116 U. S. 616).

Inspection of returns by various federal agencies.—

Regulation. . . . . 12. When the head of an executive department (other than the Treasury Department) or of any other United States Government establishment, desires to inspect or to have some other officer or employee of his branch of the service inspect a return in connection with some matter officially before him, the inspection may, in the discretion of the Secretary of the Treasury, be permitted upon written application to him by the head of such executive department or other Government establishment. The application

[5] **[Former Procedure]** This is an amendment of section 1, paragraph 1, of T. D. 2962. Formerly the Attorney General had to make a written request for an original return. Under the present Treasury decision, the Attorney General, the Assistant to the Attorney General, or an Assistant Attorney General may request an original return.

must be signed by such head and must show in detail why the inspection is desired, the name and address of the taxpayer who made the return, and the name and official designation of the one it is desired shall inspect the return. When the head of a bureau or office in the Treasury Department, not a part of the Internal Revenue Bureau, desires to inspect a return in connection with some matter officially before him, other than an income, profits tax, or corporation excise tax matter, the inspection may, in the discretion of the Secretary, be permitted upon written application to him by the head of such bureau or office showing in detail why the inspection is desired. The reasons submitted for permission to inspect as provided in this paragraph shall be considered by the Secretary and a decision reached by him whether the reasons are sufficient to permit the inspection. (Art. 1090.)

It is questionable whether "the head of an executive department (other than the Treasury Department) or of any other United States Government establishment," may legally inspect tax returns filed under any of the laws.

Inspection of corporation returns by officers of states imposing income taxes.—

LAW. Section 257. . . . . *Provided,* That the proper officers of any State imposing an income tax may, upon the request of the governor thereof, have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the Secretary may prescribe: . . . .

Federal returns of corporations are apparently available to states which impose income taxes on individuals irrespective of whether they impose a similar tax on corporations.[6] The permission, however, extends merely to corporation returns. Individual returns are not open to inspection by state officers.[7]

Inspection of corporation returns by stockholders.—The law sets forth the exact conditions which shall govern the inspection of corporate returns by stockholders.[8]

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[6] [Former Procedure] The 1916 law [section 14 (b)] permitted examination when the state imposed a "general income tax."

[7] The detailed procedure governing the inspection of corporate returns by state officers will be found in article 1092.

[8] [Former Procedure] Before the passage of the 1918 law, the Treasury regulations permitted inspection under certain conditions. (T. D. 2016, April 18. 1914).

Law. Section 257. . . . . *Provided further,* That all bona fide stockholders of record owning 1 per centum or more of the outstanding stock of any corporation shall, upon making request of the Commissioner, be allowed to examine the annual income returns of such corporation and of its subsidiaries. Any stockholder who pursuant to the provisions of this section is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return, shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000, or by imprisonment not exceeding one year, or both. . . . .

Regulation. A bona fide stockholder of record owning 1 per cent or more of the outstanding stock of a corporation shall be entitled as of right, upon making request of the Commissioner of Internal Revenue, to examine the annual income returns of such corporation and of its subsidiaries made under Titles II and III of the Revenue Acts of 1918 or 1921, and all returns of corporations filed for purposes of the tax imposed by section 1000, Title X, of said Acts. His request for permission to examine such returns must be made in writing and must be in the form of an affidavit showing his address, the name of the corporation, the period of time covered by the return he desires to inspect, the amount of the corporation's outstanding capital stock, the number of shares owned by him, the date when he acquired them, and whether he has the beneficial as well as the record title to such shares. It must also show that he has not acquired his shares for the purpose of the examination of the income returns of the corporation. If he has acquired them for this purpose he is not a bona fide stockholder within the meaning of the statute. The application must be supported by satisfactory evidence showing that the applicant is a bona fide stockholder of record of the required amount of stock of the corporation. The supporting evidence may be partly in the form of a certificate signed by the president or vice president of the corporation, and countersigned by the secretary under the corporate seal. Upon being satisfied from the evidence presented that the applicant has fully met these conditions the commissioner will grant the permission to examine the returns and set a convenient time for the examination in the office of the Commissioner. This privilege is personal and will be granted only to the stockholder, who can not delegate it to another. (Art. 1093.)

Ruling. A "stockholders' protective committee," to which deposited stock has been transferred for the purpose of safeguarding the interests of the minority stockholders, is not considered a bona fide stockholder within the meaning of section 257 of the Revenue Act of 1918. (C. B. 1, page 133; O. D. 273.)

The privilege granted by the above section is an express exception in the law. It should not be inferred from the phrase "provided by law" that a stockholder could use the figures obtained from an examination of the corporation's return on file in the Commissioner's office in a lawsuit which he might bring against the corporation.

REGULATION. A stockholder who examines the return of a corporation and reveals without express authority of law any particulars of its income statement is guilty of a misdemeanor and liable to fine and imprisonment. . . . . (Art. 1094.)

When it is desired to inspect returns of years prior to 1918, the procedure laid down in article 1090[9] must be followed.

Unofficial disclosure of information forbidden.—"Leaks" of information are occasionally heard of, but considering the opportunities for graft and the large number of government employees, there are very few violations. It is the duty of taxpayers and of those who are practicing before the Treasury, to notify the officials at once if it is believed that any confidential information has been illegally disclosed.

LAW. Section 1311. [Section 3167, Rev. Stat.] It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States to divulge or to make known in any manner whatever not provided by law to any person the operations, style of work, or apparatus of any manufacturer or producer visited by him in the discharge of his official duties, or the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; and it shall be unlawful for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses, or expenditures appearing in any income return; and any offense against the foregoing provision shall be a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court; and if the offender be an officer or employee of the United States he shall be dismissed from office or discharged from employment.

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[9] See pages 133, 134.

Referring to sections 3152, 3167, 3173 and 3176 of the Revised Statutes, a Treasury decision states:

RULING. Reading these provisions of law together, it is evident that any collector, deputy collector, agent, clerk, or other officer or employee of the Bureau of Internal Revenue, including internal revenue agents, who divulges or makes known in any manner whatsoever not provided by law the amount or source of income, profits, losses, expenditures, or any particulars thereof set forth or disclosed in any income return made by any taxpayer, or by a collector or deputy collector, or by the Commissioner of Internal Revenue, or who permits any income return or copy thereof, or any book containing any abstract or particulars thereof, to be seen or examined by any person, except as provided by law, or who prints or publishes in any manner whatever, not provided by law, any income return or any part thereof, or source of income, profits, losses, or expenditures appearing in any income return, is guilty of a misdemeanor and subject to a fine not exceeding $1,000 or to imprisonment not exceeding one year, or both, at the discretion of the court, and if he be an officer or employee of the United States, to be dismissed from office or discharged from employment. (T. D. 2903, July 30, 1919.)

List of taxpayers to be posted.—

LAW. Section 257. . . . . The Commissioner shall as soon as practicable in each year cause to be prepared and made available to public inspection in such manner as he may determine, in the office of the collector in each internal-revenue district and in such other places as he may determine, lists containing the names and the post-office addresses of all individuals making income-tax returns in such district.

The regulations are silent as to the foregoing section of the law. Since the words "shall" and "in each year" are used in the law, the posting of the lists is obligatory.

RULING. In accordance with section 257 of the Revenue Act of 1918 lists containing the names and post-office addresses of individuals making income tax returns to collectors are posted for public inspection in the public corridors of collectors' offices and post-offices. Persons will not be allowed to enter the workrooms of collectors' offices either outside or during office hours for the purpose of making copies of such lists. (C. B. 2, page 259; O. D. 531.)

Publication of statistics.—

LAW. Section 258. That the Commissioner, with the approval of the Secretary, shall prepare and publish annually statistics reasonably

available with respect to the operation of the income, war-profits and excess-profits tax laws, including classifications of tax-payers and of income, the amounts allowed as deductions, exemptions, and credits, and any other facts deemed pertinent and valuable.

Regulation. The Commissioner will publish annually a volume of statistics of income, showing, among other things, the distribution of incomes between corporations and individuals and by States, by classes and by occupations. (Art. 1101.)

Compilations of income for the calendar years 1916 to 1920 have been issued by the Treasury. See page 4.

CHAPTER VIII

PENALTIES

The penalties imposed in cases of delinquency of various types are discussed in this chapter.

Summary of Penalties in Cases of Delinquency

The following is a synopsis of penalties and interest payments for delinquencies under the Revenue Act of 1921.

UNDERSTATEMENT OF AMOUNT OF TAX

	Penalty
If not due to negligence or intentional disregard of authorized rules and regulations with knowledge thereof, or fraud. Sec. 250 (b).	½ of 1% per month from the time the tax was due (or if paid on the instalment basis, on the deficiency of each instalment from the time the instalment was due) to the extent same is not covered by any credits due to the taxpayer under section 252.
If due to negligence or intentional disregard of authorized rules and regulations with knowledge thereof, but without intent to defraud. Sec. 250 (b).	5% of the total amount of the deficiency in the tax, and interest at the rate of 1% per month on the amount of such deficiency from the time it was due (or if paid on the instalment basis, on the amount of the deficiency in each instalment from the time the instalment was due).
If any part of the deficiency is due to fraud with intent to evade tax. Sec. 250 (b).	50% of the total amount of the deficiency in the tax in lieu of penalty provided by section 1311 (R. S. 3176) but in addition to specific penalties (see section 253).
False or fraudulent return or list willfully made. Sec. 1311 (R. S. 3176).	50% of amount of tax in addition to specific penalties (but not in addition to the 50% penalty in preceding section). (See section 253.)

	Penalty
Willful attempt to evade tax (applies to taxpayer, officers and employees). Sec. 253.	Maximum fine $10,000, or maximum imprisonment one year, or both, with costs, in addition to ad valorem penalties. [See sections 250 (b) and 1311.]

Failure to File Return of Information

Failure to file when due. Sec. 253.	Maximum fine $1,000; in addition to ad valorem penalty. (See section 1311 below.)
Willful refusal to make return or willful attempt in any manner to defeat or evade the tax. Sec. 253.	Maximum fine $10,000, or maximum imprisonment one year, or both, with costs, in addition to ad valorem penalty. (See section 1311 below.)
Failure to file when due (unless shown to be due to reasonable cause). Sec. 1311 (R. S. 3176).	25% of amount of tax in addition to specific penalty. (See section 253 above.)
Failure to file true and correct copy of any government contract on request. Sec. 1408 (1918 act).	$1,000 fine, one year imprisonment, or both.

Failure to Pay Tax When Due

When extension is granted for filing final returns. Sec. 250 (a).	½% per month interest on amount of deficiency, if any, in initial instalments.
When instalment is not paid when due. Sec. 250 (a).	Entire tax becomes due and payable on notice and demand; 5% on amount due and unpaid; 1% per month interest in addition to specific penalty. (See section 253.)
Failure to pay when due, unless covered by a *bona fide* claim for abatement which was filed within ten days after notice and demand by the collector, and without the taxpayer having had the benefit of the provisions of subdivision (d) of section 250, in which case the claim carries interest at ½ of 1% per	5% on amount due, 1% per month interest in addition to specific penalty. (See section 253.)

	Penalty
month except claims for inventory losses (under 1918 act) interest on which is 1% per month. [See sections 214 (a-12) and 234 (a-14), 1918 act.] (This applies to taxes under 1917, 1918 and 1921 acts.) Sec. 250 (e).	
When extension is granted for paying deficiency in tax under 1917, 1918 or 1921 act. Sec. 250 (f).	Within period of 18 months from passage of 1921 act (November 23, 1921), extension may be granted for paying deficiency upon cause shown. From date of extension until payment of interest at rate of ⅔ of 1% per month, except when such interest provided by law is in excess thereof.
When deficiency or any part thereof is not paid in accordance with the terms of extension granted. Sec. 250 (f).	5% of the amount of the deficiency, and interest on the deficiency at the rate of 1% per month from the time it became payable, in accordance with the terms of the extension, in lieu of other penalties and interest that would attach under the law.
When, after Commissioner has taken action under this section, a taxpayer violated or attempts to violate the provisions thereof; also when an alien violates or attempts to violate the provisions of this section relating to the securing of certificate prior to departure from the United States (with respect to taxes under 1917, 1918 and 1921 acts). Sec. 250 (g).	25% of the total amount of the tax or the deficiency in the tax, together with interest at the rate of 1% per month from the time the tax became due, in addition to all other penalties.
Failure to pay or collect tax at time required. Sec. 253.	Maximum fine $1,000 in addition to ad valorem penalty. (See section 250.)
Willful refusal to pay tax when required (applies to taxpayer, officers and employees). Sec. 253.	Maximum fine $10,000, maximum imprisonment one year, or both, with costs, in addition to ad valorem penalty. (See section 250.)

Penalties for failure to make return.—There are two penalties for failure to file a return, viz., a specific fine and a percentage (ad valorem) penalty. The former can be imposed only by the courts, while the latter may be assessed by the Commissioner.[1]

PENALTY OF FINE.[2]—

LAW. Section 253. That any individual, corporation, or partnership required under this title to pay or collect any tax, to make a return or to supply information, who fails to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, shall be liable to a penalty of not more than $1,000. . . . .

PENALTY OF 25 PER CENT ADDITIONAL TAX.[3]—

LAW. Section 1311. [Section 3176, Rev. Stat.] " . . . . In case of any failure to make and file a return or list within the time prescribed by law, or prescribed by the Commissioner of Internal Revenue or the collector in pursuance of law, the Commissioner of Internal Revenue shall add to the tax 25 per centum of its amount, except that when a return is filed after such time and it is shown that the failure to file it was due to a reasonable cause and not to willful neglect, no such addition shall be made to the tax.[4] . . . ."

REGULATION. . . . . If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return in the prescribed time, then the delay is due to "reasonable cause." . . . . (Art. 1004.)

Failure must be "due to a reasonable cause and not to willful neglect." It is no longer considered necessary in addition that the return be filed "voluntarily and without notice

[1] Art. 1055. The above penalties are for cases where the failure to file return or pay tax is not "willful." For penalties in cases of willful refusal to file return or pay tax, see page 152.

[2] [Former Procedure] The language is the same as in the 1918 law. A minimum fine of $20 was provided by section 18 of the 1916 law.

[3] [Former Procedure] The language is the same as that of the 1918 law. Fifty per cent under 1916 law (section 16).

[4] In the case of this 25 per cent penalty as well as the 50 per cent penalty for false or fraudulent list, "The amount so added to any tax shall be collected at the same time and in the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, falsity, or fraud, in which case the amount so added shall be collected in the same manner as the tax." (Law, section 1311, section 3176, Rev. Stat.)

from the collector."[5] Such voluntary filing, however, is obviously the best possible evidence that the failure to file was due to a reasonable cause and not to willful neglect. The regulations in the past have prescribed that the penalty of increased tax shall be remitted only if the cause "is found to be reasonable." It can be assumed that any cause short of fraud or willful neglect will be deemed to be reasonable.

In the case of *Gilligan v. The Dayton Bronze Bearing Company,*[6] the United States Circuit Court of Appeals for the Sixth Circuit placed a liberal interpretation on the phrase "voluntary and without notice from the collector." In this case an agent of the Internal Revenue Department visited the taxpayer "at which time the question of the company's liability was freely and frankly discussed by the officers of the company. . . . . Shortly following this, the taxpayer, pursuant to the advice of the collector, filed a voluntary return." The court ordered that the penalty with interest be refunded.

Ruling. Where the attendant and surrounding circumstances have a tendency to cast doubt and suspicion upon a taxpayer, a plea of mere ignorance is not sufficient to constitute a reasonable cause for failure to make and file a return within the time prescribed by law for the purpose of being relieved of the penalty. (C. B. 1, page 247; O. 818.)

Article 1004, quoted above, further declares that to avoid the penalty, the taxpayer should attach to the return an affidavit showing the facts alleged as a reasonable cause for failure to make the return in due time. The Commissioner passes upon

[5] **[Former Procedure]** Section 16 (section 3176, Rev. Stat.).

During 1921 the Solicitor made a more liberal interpretation of this section of the law. The 50 per cent penalty is imposed only where there has been "a refusal or inexcusable neglect" to file a return.

Ruling. A mere failure to file a return as required by and within the time prescribed in the Act of October 3, 1913, does not of itself constitute a "refusal or neglect" to file such return within the meaning of section 3176 R. S., as amended by the Act of October 3, 1913.

The Commissioner is authorized and required to add the 50 per cent to the tax provided for in section 3176, R. S., as amended by the Act of October 3, 1913, only where there has been a refusal or inexcusable neglect on the part of the taxpayer to file the return within the time prescribed by law. (C. B. 4, page 318; Digest L. O. 1060.)

[6] 281 Fed. 709.

the validity of the showing and without his consent no remission is made. Relief from the ad valorem penalty does not necessarily relieve the taxpayer from liability to the specific fine.[7]

Ruling. (1) The ad valorem penalties for fraudulent returns should be assessed against withholding agents[8] under the income tax provisions of the law.

(2) The ad valorem penalties for delinquent returns should be assessed against withholding agents under the income tax provisions of the law, except that if the tax required to be withheld is paid by the recipient of the income, no such penalty should be collected from the withholding agent unless his delinquency was fraudulent and for the purpose of evading payment. . . . . (C. B. 2, page 229; S. 1334.)

The 50 per cent penalty for false or fraudulent returns.— The 50 per cent penalty applies only to false or fraudulent returns. This penalty also becomes a part of the tax and may be assessed by the Commissioner.

Law. Section 1311. [Section 3176 Rev. Stat.] . . . . In case a false or fraudulent return or list is willfully made, the Commissioner of Internal Revenue shall add to the tax 50 per centum of its amount.[9] . . . .

Law. Section 250. . . . . (b) . . . . If any part of the deficiency is due to fraud with intent to evade tax, then, in lieu of the penalty provided by section 3176 of the Revised Statutes, as amended, for false or fraudulent returns willfully made, but in addition to other penalties provided by law for false or fraudulent returns, there shall be added as part of the tax 50 per centum of the total amount of the deficiency in the tax. In such case the whole amount of the tax unpaid, including the penalty so added, shall become due and payable upon notice and demand by the collector. . . . .

The distinction between the penalties imposed by the two sections quoted, is that under the former the 50 per cent penalty is computed on the full amount of the tax correctly payable (both original and additional assessments), whereas under the latter section the penalty is computed only on the

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[7] See page 147.

[8] The Solicitor states that he sees no good reason why this penalty should not be applied to withholding agents. (C. B. 1, page 261; O. 907.)

[9] [Former Procedure] Prior to 1918, section 3176 of the Revised Statutes provided for a penalty of 100 per cent.

deficiency of tax, i.e., the amount of tax under-reported on the false or fraudulent return.

In view of the notice by the Commissioner that "tax slackers" are to be severely dealt with, it should be noted that in addition to all other penalties there will be added to the deficiency in tax an additional 50 per cent thereof. Determination of what constitutes a false return will depend on the circumstances of each case, but it is reasonable to suppose that the wide publicity during the last several years given to all income tax matters will put the burden of proof upon every citizen who makes an understatement, and when it is found that there has been a failure to report income it will be much more difficult than heretofore to claim ignorance of the law.

RULINGS. "Understatement" as used in section 250 (b) has particular reference to the understatement of the amount of the tax in the return. This is true whether such understatement resulted from the false or fraudulent computation of the tax or from false or fraudulent misstatements or omissions of items of income or misstatements of items of deduction or from other false or fraudulent entries or omissions.

Section 250 (b), providing for the addition as part of the tax 50 per centum of the amount of the deficiency, and not section 3176, R. S., as amended by the revenue act of 1918, is applicable to income and profits tax matters arising under the revenue act of 1918, where there is an understatement of the amount of the tax in the return and the understatement resulted from fraud with intent to evade the tax. In all other cases of false or fraudulent returns willfully made in matters arising under the revenue act of 1918, section 3176, Revised Statutes, as amended by that act, is applicable. (C. B. 2, page 232; O. 1008.)

A taxpayer who filed a return of income which did not include profit on the sale of certain corporate stock and in reply to an inquiry by an examining officer stated that he had not made any money on outside investments during the year, but in reply to a direct inquiry in regard to the sale of the stock, based on confidential information, admitted the sale, but made no explanation of his failure to include the profit on the sale in his return for the taxable year, is held to have filed a false and fraudulent return for the purpose of evading taxation and the 100 per cent additional tax should be assessed. (1913 Act.) (C. B. 1, page 248; S. 926.)

In *Levy v. United States,*[10] the defendant made an amended income and excess profits tax return which was proved to be false. It was urged that the offense related to an "amended" return and no return of that character was known to criminal law. The court held that while amended returns may not be prescribed by statute, they nevertheless fall within its contemplation.

In *United States v. Rachmil,*[11] it was held, in an indictment for conspiracy to evade payment of an income tax, that the preparation, signing, and acknowledgment of a false return, alleged as overt acts, would not constitute an attempt to evade payment of the tax. However, the filing of the false return with the collector would be such an attempt.

RULINGS. Where an income tax return under the Revenue Act of 1916, or an income or excess profits tax return under the Revenue Act of 1917, has been found to be false and fraudulent and the additional tax has been assessed and paid at a time when the grounds for asserting the 100 per cent fraud penalty under section 3176 R. S., as amended by the Revenue Act of 1916, were fully known to the department, no fraud penalty may be thereafter assessed; where under such circumstances the additional tax has been assessed but not paid or paid but not assessed, the fraud penalty may still be assessed.

The rule under the Revenue Act of 1918, however, is different. The 50 per cent fraud penalty under section 250 (b) thereof may be subsequently assessed although the additional tax has been both assessed and paid after the discovery of the fraud.

Under all three of these Acts, if the additional tax has been assessed or paid, or assessed and paid prior to discovery of the fraud, the penalty may be assessed at any time after the discovery and within the statutory period for assessment of taxes. . . . . (C. B. 3, page 290; Sol. Op. 52.)

. . . . Taxes may be collected by suit, whether assessed or not, but this is not true with respect to ad valorem penalties which can not be collected by suit without first having been assessed; furthermore even though they have been assessed they may not be collected by suit after five years from the time they accrued.

A waiver by a taxpayer of his rights as to the limitation of assessment of taxes does not carry with it a similar waiver as to the assessment of ad valorem penalties. (C. B. 3, page 295; Digest Sol. Op. 60.)

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[10] 271 Fed. 942.
[11] 270 Fed. 869.

The foregoing ruling was made for a specific case in which the taxpayer had filed in 1918 amended returns for the years 1909 to 1916, inclusive. Under the amended returns the net income was shown to be much larger than was originally reported. The Treasury held that, inasmuch as the books clearly reflected the correct net income and the original returns did not, there was evidence of fraud. Furthermore it was held that the real purpose of filing the amended returns was to secure a large invested capital for 1917, which had been reduced by various understatements in original returns.

Penalty for willful refusal to make return or attempt to evade—fine or imprisonment.—

Law. Section 253. . . . . **Any individual, corporation, or partnership, or any officer or employee of any corporation or member or employee of a partnership, who willfully refuses to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, or who willfully attempts in any manner to defeat or evade the tax imposed by this title, shall be guilty of a misdemeanor and shall be fined not more than $10,000[12] or imprisoned for not more than one year, or both, together with the costs of prosecution.**

Regulation. . . . . If the failure is willful, however, or an attempt is made to defeat or evade the tax, the offender is liable to imprisonment and to a fine of not more than $10,000 and costs. See also the Act of July 5, 1884. In addition to these specific penalties ad valorem penalties are imposed in various cases. An ad valorem penalty is assessed and collected as a part of the tax, while a specific penalty is enforceable only by suit. . . . . (Art. 1055.)

Rulings. The giving of instructions or advice with the purpose and intent of inducing persons liable to make income returns or pay income tax to refrain from making such returns or paying such tax is an attempt to defeat the tax within the meaning of the statute, and those giving such instructions or advice are amenable thereto. (C. B. 1, page 259; S. 931.)

If a citizen about to leave the United States willfully refuses to pay such tax as is properly due, he may be arrested and detained for the purpose of facing prosecution criminally for a violation of section

[12] **[Former Procedure]** The language is the same as in the 1918 law. Under the earlier laws the fine applying to individuals was restricted to $2,000 (1917 law, section 18).

253 of the Revenue Act of 1918. Furthermore, the district courts of the United States, at the instance of the United States, are vested with jurisdiction to make and issue writs and orders of injunction and ne exeat republica and such orders and process as may be necessary or appropriate for the enforcement of the provisions of the Revenue Act of 1918. (Sec. 1318.) With respect to these provisions a citizen departing is in no different position from a citizen continuing in the United States—the Act being enforceable alike against taxpayers continuing in the United States and taxpayers departing from the United States. (C. B. 1, page 260; O. D. 168.)

The foregoing relates to tax which is due and should not be confused with the provisions of section 250 (g).[13]

Imperfect returns not acceptable.—Notwithstanding the requirement of the Treasury that taxpayers must secure the approval of the Commissioner to file tentative returns, the following would seem to admit the possibility of filing tentative returns without specific permission:[14]

Regulation. . . . . Each taxpayer should carefully prepare his return so as fully and clearly to set forth the data therein called for. Imperfect or incorrect returns will not be accepted as meeting the requirements of the statute. In lack of a prescribed form a statement made by a taxpayer disclosing his gross income and the deductions therefrom may be accepted as a tentative return, and if filed within the prescribed time a return so made will relieve the taxpayer from liability to penalties, provided that without unnecessary delay such a tentative return is replaced by a return made on the proper form. . . . . (Art. 407.)

The author is of the opinion that article 407 places a correct interpretation upon the law. If a taxpayer is able to file only a tentative return on the due date, he has filed a return within the meaning of the law. A complete return should be filed as soon as possible. Of course taxpayers are not excused from the obligation to request extensions of time, which are freely granted in all meritorious cases. The foregoing discussion concerns taxpayers who without negligence have failed to secure formal extensions of time.

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[13] See Chapter XI.

[14] See clause 4, Mim. 1675, page 163.

Understatements.—

PENALTY FOR UNDERSTATEMENT.—If it appears that an understatement of the amount of tax due has been made in good faith, no penalty is imposed because of such understatement, but if due to negligence or "intentional disregard" of Treasury procedure, a penalty of 5 per cent is added to the additional tax, plus interest at the rate of 12 per cent per annum.

LAW. Section 250. . . . . (b) . . . . If any part of the deficiency is due to negligence or intentional disregard of authorized rules and regulations with knowledge thereof, but without intent to defraud, there shall be added as part of the tax 5 per centum of the total amount of the deficiency in the tax, and interest in such a case shall be collected at the rate of 1 per centum per month on the amount of such deficiency in the tax from the time it was due (or, if paid on the installment basis, on the amount of the deficiency in each installment from the time the installment was due), which penalty and interest shall become due and payable upon notice and demand by the collector. . . . .[15]

NEGLIGENCE OR INTENTIONAL DISREGARD.—It is therefore of importance to taxpayers that, if an additional assessment is made, care be taken to produce evidence that there was no negligence involved, but that on the contrary the return was made in good faith and not due to any fault of the taxpayer.

REGULATION. . . . . Negligence is the absence of reasonable care under the circumstances. . . . . (Art. 1005.)

Of course, if the instructions on the return are contrary to the law, it is not necessary to follow them. It is good practice, however, to indicate how and why the instructions were not followed. This position is confirmed by the Committee on Appeals and Review.

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[15] [Former Procedure] The phrase "intentional disregard of authorized rules and regulations with knowledge thereof" was transferred to the 1921 law from the regulations. The 1918 law contained the following statement:

LAW. Section 250. . . . . (b) . . . . . if the return is made in good faith and the understatement of the amount in the return is not due to any fault of the taxpayer, there shall be no penalty because of such understatement. . . . .

Ruling. Held, that the 5 per cent penalty for negligence should not attach in any case where a complete disclosure of all the facts is made by the taxpayer in the return so that the Department can make an assessment of additional tax if it desires to do so. (C. B. 4, page 322; Digest A. R. M. 105.)

The foregoing was a case where appreciation was included in invested capital.

The following ruling of the Committee is also of interest:

Ruling. The penalty for negligence should not be asserted against a corporation where the amount of a contribution to the Red Cross and other similar war works was specifically and separately listed in the schedule of general expenses supporting item 12 in its return for 1918. (C. B. 4, page 322; Digest A. R. R. 360.)

The detailed opinion stated that:

There was no specific instruction on the return form dealing with contributions to the Red Cross and other similar war works, and it is a known fact that many lawyers and tax consultants of ability were of the opinion, and so advised their clients, that contributions to these objects under conditions that existed in 1918 when the United States was at war, were legitimate and proper deductions in determining net income, not of course as charitable contributions under section 214 (a) 11 but as ordinary and necessary expenses of business. That the Bureau itself had not made up its mind on this question is clearly indicated by the fact that the question was submitted to the Attorney General for an opinion which at the date of filing the return had not been rendered.

If the mistake is one of which an average reasonable man might be capable, the 5 per cent penalty will not be imposed. It is obvious that the penalty will not be imposed when arithmetical or other errors have been made, provided only that they are such errors as the average man may make. The honest taxpayer can point out in his defense many conflicting and ambiguous regulations.

In view of the complexities and ambiguities of the law, which are recognized by the Treasury itself, no reasonably careful person need fear this penalty. Of course, if a mistake results in a very large understatement of the tax, the whole burden of proof is placed upon the taxpayer to show that he was not on notice that a mistake had probably been made, because

there are available methods of approximating the amount of tax due upon a given amount of net income.

The Treasury has imposed penalties when the returns rendered were incorrect, interpreting "incorrect" to mean "incorrect, misleading, false and fraudulent" in view of the facts in particular cases.

RULINGS. "Negligence on the part of the taxpayer, but without intent to defraud" is presumed to exist in every case in which a deduction has been made or income has been omitted in direct conflict with the specific provisions of the law and regulations, but is not presumed to exist if the understatement may be ascribed to an error of judgment as to some matter not so concluded. . . .

. . . . This section [250 (b)] places upon the taxpayer the duty of knowing and understanding such parts of the regulations as are applicable to the submission of his return. This requirement should not be carried to the extent of expecting the judgment of the taxpayer on questions involving judgment to concur exactly with the judgment of representatives at the Bureau. If the understatement is due to writing off more depreciation than is proper, in the judgment of representatives of the Bureau, or the deduction of salaries which are excessive, or similar approximations, then negligence can not be imputed to the taxpayer, unless the position taken is so unreasonable as to indicate bad faith. . . . (C. B. 2, page 231; A. R. M. 23.)

Where, through fraud with intent to evade tax, an understatement of the amount of the tax in an income tax return results, the understatement is false or fraudulent and the 50 per cent of the whole amount of the deficiency is required to be added to the tax. The 5 per cent penalty provided for understatements due to negligence has no application to any part of the deficiency in such a case. . . . (C. B. 2, page 233; O. 1028.)

If a taxpayer in preparing his tax return for 1920 omitted from gross income the gain derived from the sale of capital assets, and failed to make a full disclosure of the facts pertaining to the transaction, the Bureau holds he is guilty of negligence or fraud, as the case may be, for making the understatement.

Collectors should so far as possible expedite the examination of the returns as filed to discover those cases in which the taxpayer omitted from gross income the gain derived from the sale of capital assets and made a full disclosure. If a full disclosure was made, negligence will not be imputed to the taxpayer. These returns should be reported to the Commissioner on Form 23-A in the usual manner prior to the serving of notice and demand. After the Commissioner has assessed the tax on the basis of the collectors' lists, the collectors

shall immediately serve, upon Form 17, notice and demand for the additional tax due, and after the ten-day period proceed to collect the tax, plus interest and the penalty for delinquency, as provided for in section 250 (e) of the Revenue Act of 1918, by distraint if necessary.' (C. B. 4, page 72; Digest Mim. 2791.)

Any interest paid under section 250 should be charged to an expense account as the same is a deductible item in arriving at taxable income.[16]

NEGLIGENCE CANNOT BE IMPUTED WHEN DISCLOSURE IS MADE.—A taxpayer in its 1918 return did not deduct excess profits taxes from invested capital but disclosed its method of computation: the income tax unit assessed 5 per cent penalty for negligence in not complying with the regulations (Art. 845, Reg. 45). The unit was sustained in A. R. R. 454 (not published). After payment, claim for refund was filed. The Solicitor held that "negligence is the want of due care or the absence of due care; that where due care is exercised clearly, therefore, negligence does not exist." He also held that the company was "at fault" in not following the regulations but was not negligent and that the claim for refund should be allowed.

The Solicitor cited numerous court decisions defining the word "negligence" (I-44-573; A. R. R. 1167).

NO PENALTY WHEN UNDERSTATEMENT IS MADE IN GOOD FAITH.—If claim for abatement is made and denied,[17] interest at the rate of 6 per cent per annum is charged from the date originally fixed for payment of the additional assessment on such part of the claim as has been denied. The interest charge at the rate of 6 per cent (instead of 12 per cent) depends upon whether or not the claim for abatement was "bona fide."[18]

Taxpayers who make claims in good faith may confidently

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[16] For a ruling concerning penalties for an understated return of community property, see Chapter XVI.

[17] Under the 1921 law claims for abatement may be filed only in a few instances. See Chapter XII.

[18] Section 250 (e).

rely upon the Commissioner to accord to them the benefit of the 6 per cent rate.[19]

Failure or delay in payment.—

Specific penalty.—

Law. Section 253. That any individual, corporation, or partnership required under this title to pay . . . . any tax, ... who fails to pay . . . . such tax, ... shall be liable to a penalty of not more than $1,000. Any individual, corporation, or partnership, or any officer or employee of any corporation or member or employee of a partnership, who willfully refuses to pay . . . . such tax, ... at the time or times required under this title, ... shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

The specific penalties mentioned in the foregoing section of the law, that is, those of not more than $10,000, are collectible only by suit. What are known as ad valorem penalties, such as the 25 per cent and 50 per cent penalties, are assessed and collected as a part of the tax and increase the tax accordingly.[20]

No interest on penalties.—The interest charge of 1 per cent a month imposed upon taxes overdue applies only to the amount of tax, not to any specific penalties which may be imposed.

Penalty of percentage and interest.—

Law. Section 250. . . . . (e) If any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, then, except in the case of estates of insane, deceased, or insolvent persons, there shall be added as part of the tax the sum of 5 per centum on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time it became due: *Provided,* That as to any such amount which is the subject of a bona fide claim for abatement filed within ten days after notice and demand by the collector, where the taxpayer has not had the benefit of the provisions of subdivision (d), such sum of 5 per centum shall not be added and the interest from the time the amount was due until the

[19] [Former Procedure] Prior to the 1918 law the rate was 12 per cent per annum.

[20] See pages 147, 149.

claim is decided shall be at the rate of one-half of 1 per centum per month on that part of the claim rejected. . . . .

The circumstances in which penalty interest is collected are set forth in the following regulation:

Regulation. Where the time for the payment of any installment of the tax is postponed at the request of the taxpayer, interest at the rate of 6 per cent per annum is added from the original due date until paid. Except in the case of estates of insane, deceased, or insolvent persons, if any tax remains due and unpaid for 10 days after notice and demand by the collector (in the case of the first installment the instructions printed on the return and the taxpayer's computation of the tax on the return constitute notice and demand) there shall be added as part of the tax 5 per cent of the amount due but unpaid, plus interest at the rate of 12 per cent per annum from the due date, except that the interest on any amount which is the subject of a bona fide claim in abatement filed within 10 days (where the taxpayer has not had the benefit of the notice and the 30-day period for filing an appeal as provided in sec. 250 (d) and art. 1006) shall be at the rate of 6 per cent per annum and the 5 per cent penalty shall not be added. Upon receipt of notice of rejection of claim in abatement (or so much thereof as is not allowed) the collector will notify the claimant and demand payment of the tax. If the tax is not then paid within 10 days the 5 per cent penalty will be assessed on the amount of tax not abated. If abatement of the entire tax was not requested and the balance of the tax was not paid within the required 10 days, the 5 per cent penalty accrues immediately on such balance. Interest is to be added in all cases in which the demand of payment is made of the taxpayer personally, although he subsequently dies, or becomes insane or insolvent, so that collection of the tax is made from his estate in the hands of his legal representative; but the estate of a deceased person, regardless of the date of his death, or of an insane or insolvent person, can not be charged with liability to the 5 per cent penalty on account of his or the fiduciary's delinquency in making payment of the tax. . . . . This article applies to the assessment and collection of taxes which have accrued or may accrue under the Revenue Act of 1918, and the Revenue Act of 1921, and except insofar as it relates to the installment plan of payment, under the Revenue Act of 1917. (Art. 1003.)

Rulings. Where a tax is placed on the assessment list after the dissolution of the corporation against which it is assessed, the former stockholders of the dissolved corporation are not liable to the 5 per cent penalty and 1 per cent per month interest on account of the failure of the dissolved corporation to pay the tax within 10 days after notice and demand. (I-39-520; I. T. 1455.)

The interest collectible under section 250 (e)[21] of the Revenue Act of 1918 upon the amount of tax due and unpaid 10 days after notice and demand by the collector should be computed only upon the amount of tax shown by the return to be due, and not upon the tax plus the five per cent penalty. (C. B. 3, page 290; O. D. 725.)

But if the taxpayer has been subjected to the 25 per cent or 50 per cent penalty, the 5 per cent penalty and interest are computed upon the amount of the tax plus the penalty.

Rulings. In cases where an addition of 25 per cent or 50 per cent is made to the tax on account of delinquency or fraud, and the taxpayer fails to pay the tax within 10 days after notice and demand from the collector, the 5 per cent penalty, and interest attach not only to the amount of tax shown to be due by the return, but also to the 25 per cent or 50 per cent addition to the tax. (C. B. 2, page 229; O. D. 441.)

A filed an amended return showing a lesser amount of tax due than was shown in his original return, but did not file a claim for abatement of the excess tax shown in his original return until after 10 days following notice and demand from the collector for payment of the tax due, assuming that the amended return was a substitute for the original return. The claim was subsequently allowed.

The 5 per cent penalty and 1 per cent interest will not be asserted for the reason that the allowance of the claim for abatement is evidence of the fact that the tax was not originally actually due and payable by the taxpayer. (C. B. 4, page 324; O. D. 846.)

. . . . Where a delinquent return is filed and the whole amount of tax is paid at the time of filing, the penalty of 5 per cent of the first installment attaches and also the interest on such installment at the rate of 1 per cent per month from the due date of the return, as fixed by statute, to the time the tax was actually paid, the due date in the case of the taxpayer rendering his returns on a calendar year basis being March 15. The instructions on the return constitute notice and demand for the first installment only, and where the first installment is not paid on or before the due date, such penalty and interest provisions apply to so much of the first installment as was not paid on time. The balance of the tax over and above the amount of the first installment becomes due and payable upon notice and demand by the collector. If the whole or any part of such balance remains unpaid after 10 days from such notice and demand, the penalty and interest provisions of section 250 (e) apply to the unpaid amount.

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[21] See page 158.

The first installment is due at the time fixed by law for filing the return; that is, on March 15 in the case of returns made on a calendar-year basis. The law also provides that the instructions printed on the return are deemed sufficient notice and demand. Accordingly, if the first installment is not paid on March 15, it becomes delinquent, and in such cases the 5 per cent penalty and interest at the rate of 1 per cent per month, from March 16, should be collected on the first installment.

The 5 per cent penalty is assessed by law; it is asserted, compromised, or waived as the case may be, by the Department.

O. D. 313, C. B. 1, page 249, overruled. (C. B. 5, page 238; O. D. 1111.)

PENALTIES APPLY ONLY AFTER NOTICE AND ASSESSMENT.—Penalties for failure or delay in the payment of tax are not applied until after assessment has been made and notice has been given to the taxpayer, except (1) when extensions of time are secured by taxpayers,[22] and (2) when there is negligence (without intent to defraud) on the part of the taxpayer.

RULING. No interest is collectible on the difference between the amount of tax paid on the basis of an original return and that shown to be due by an amended return if the understatement in the original return was not due to negligence of the taxpayer. (C. B. 3, page 290; O. D. 691.)

Penalties in case of death or bankruptcy of delinquent.—Section 250 (e) of the law specifically exempts "estates of insane, deceased or insolvent persons" from the 5 per cent penalty and interest at the rate of 1 per cent a month otherwise imposed if the tax remains unpaid after ten days notice and demand.[23]

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[22] Sections 250 (a) and 250 (f).
[23] Also see Bankruptcy Act, section 57 (f), quoted in C. B. I-1; page 302; I. T. 1209.

[Former Procedure] Under the 1918 law, exemption from penalty, however, did not extend to a decedent's estate when claim for abatement on the ground of loss in inventory had been disallowed. Section 214 (a-12), covering inventory claims, does not mention estates, etc., as in section 250 (e), this distinction apparently being the basis for the following:

REGULATION. . . . . But if any part of a claim for abatement on the ground of a loss in inventory under section 214 (a) (12) . . . . of the statute is disallowed, interest from the original due date at the rate of 12 per cent per annum will be added to the tax not abated; and interest is to

The exemption also applies to the 6 per cent interest added when claims for abatement are disallowed.

REGULATION. . . . . the estate of a deceased person, regardless of the date of his death, or of an insane or insolvent person, cannot be charged with liability to the 5 per cent penalty on account of his or the fiduciary's delinquency in making payment of the tax.[24] . . . . (Art. 1003.)

Penalty paid on illegal tax may be recovered.—In *Camp Bird v. Howbert,*[25] it was held that, where an illegal tax is paid, the fact that it was not paid within the time allowed by law will not prevent any taxpayer from recovering the penalty of 1 per cent per month paid by him for the non-payment of an illegal tax. If the tax was illegal it was never due and therefore the penalty was as much unauthorized as the tax itself.

Compromise of penalties.—In an opinion[26] dated June 3, 1919, the United States Attorney General held that claims falling in the following classes may be compromised by the Commissioner whenever, in his judgment, such compromises are for the interest of the United States:

(1) Claims for amounts 50 per cent in addition to amounts of income and excess-profit taxes assessed under authority of section 3176 of Revised Statutes, as amended by section 16 of the act of September 8, 1916, and of section 212 of the act of October 3, 1917, in cases of failure to make and file returns or lists within the time prescribed by law or by the collector;

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be added in all cases in which the demand of payment is made of the taxpayer personally, although he subsequently dies, or becomes insane or insolvent, so that collection of the tax is made from his estate in the hands of his representative. . . . . [Reg. 45 (1918), Art. 1003.]

[24] **[Former Procedure]**
REGULATION. Specific penalties provided by the income tax law are held to attach to the person and in case of death of such person are non-enforceable.
Ad valorem penalties (those measured by income) attach to income and are to be enforced regardless of the death of the owner of the income by which the penalty is measured. (Reg. 33, 1918, Art. 52.)

[25] 262 Fed. 114. Petition for writ of certiorari denied, March 8, 1920, 252 U. S. 579, 64 L. Ed. 725, 40 Sup. Ct. 344.

[26] 31 Op. A. G. 459.

[Former Procedure] Prior to this opinion it was held by some authorities that the Commissioner had no power to mitigate the 25 and 50 per cent penalties.

(2) Claims for amounts 100 per cent in addition to amounts of income and excess-profit taxes assessed under authority of said sections in cases of false or fraudulent returns or lists willfully made; . . . .

Collectors have no authority to waive penalties or interest.[27] The Solicitor has held that "offers in compromise rest upon the same legal principles as ordinary contracts."[28]

When specific penalties will not be subject of suit.—In view of the extraordinary conditions now existing it is believed by some that many taxpayers have rendered themselves liable to penalties. Under the circumstances it may be of interest to reproduce instructions to collectors regarding the imposition of the specific penalties and the attempt to recover them by suit.

RULING. Liability to specific penalty attaches upon all delinquent returns and is recoverable by suit. By Section 3214 R. S. the Commissioner of Internal Revenue may or may not institute suit. It has been decided not to institute suit nor to assert specific penalty in certain cases. The assertion of specific penalty does not depend upon the fact of whether or not the 50 per cent addition to tax has been assessed. In some cases where the 50 per cent addition to tax must be assessed because the return was filed after notice from the collector, the specific penalty will not be asserted. It will not be asserted, regardless of whether the 50 per cent addition to tax has been assessed, in cases falling under any of the following designations:

1. Extension granted. Where a return is filed within the thirty-day period of extension granted by the collector or within a further period of extension granted by the Commissioner of Internal Revenue, as provided by Section 14 (c) of the act of September 8, 1916.

2. Return on time. Specific penalty will not be asserted upon an amended return provided the original return was filed within the prescribed time.

3. Mailed in time. Where an affidavit is filed satisfactorily establishing that the return was placed in the mails in ample time to reach the collector's office in ordinary course of mails before the close of business on the final day for filing.

4. Tentative return. Where an informal return was filed within the time prescribed. The return of a parent company including therein the income of a subsidiary company will be accepted as a ten-

[27] C. B. I-1, page 305; I. T. 1161.
[28] C. B. 2, page 239; Sol. Op. 7.

tative return of the subsidiary company, if the fact is stated that the tentative return includes the income of the subsidiary.

5. Filed in wrong district. Where the return was filed in some other collection district within the prescribed time.

6. Net income under $3,000. Where it develops that the net income of an individual for 1913, 1914, 1915 or 1916 was less than $3,000, or under the act of October 3, 1917, for 1917, etc., less than $1,000 or $2,000.

7. Erroneous information. Where the delinquency is alleged to be due to erroneous or misleading information given by officials or employees of the Internal Revenue Service and there is no evidence in conflict therewith.

8. Organization incomplete. Where it is established that the organization of a corporation, joint-stock company or association, or insurance company was not completed until after the expiration of the period for which the return should have been filed.

9. Death. Where by reason of the death of an individual his return for the year or portion of the year prior to his death is not filed within the time prescribed. The death of a delinquent abates liability to specific penalty. An administrator or executor is charged with the duty of rendering a return for the decedent, and if he is appointed in ample time to make the return prior to March 1 and fails to do so, he should be charged as delinquent and the specific penalty should be asserted against him. The administrator or executor will not be relieved from specific penalty unless the return is made within a reasonable time after his appointment.

10. Severe illness or unavoidable absence. Where it is clearly established that the delinquency in the filing of a return of an individual or of a corporation within the time prescribed was due to severe illness of the individual or of an officer of a corporation whose duty it was to prepare or sign the return, or to unavoidable absence from place of business or place of abode.

11. Absence from the United States. Where it appears that the filing of a return within the time prescribed was rendered impossible by reason of absence from the United States. Delinquency beyond the period of extension which may be granted by the Commissioner of Internal Revenue will not be excused under this heading.

12. Military or naval service of United States. Where the delinquency of an individual was occasioned by service in the military or naval forces of the United States.

13. Not organized for profit. Comprehends numerous small corporations not organized primarily for profit, such as local telephone companies, co-operative purchasing societies, etc., concerning whose liability under the law to make a return there may have been a reasonable doubt.

14. Inactive corporations. Those which transacted no business and had no income during the return year.

15. Fiscal year. Corporations which have established a fiscal year in the manner prescribed by law which file a return on or before the first day of the third month following the close of the fiscal year.

16. Assigned. Where corporations have made an assignment on account of insolvency and do not intend again to engage in business.

17. Insolvent. Where the assets of a corporation are insufficient for the payment of its debts and the corporation has ceased to do business.

18. Charter forfeited. Where, prior to the date when the return was due, the charter of a corporation is forfeited on account of non-compliance with state laws. It must be clear, however, that business in the name of the corporation was suspended at the time of such forfeiture. If business was continued under the same name, the concern will be held to be an association and the same liabilities will attach as if the charter had not been forfeited.

19. Defunct. Where corporations are out of business, have no assets, maintain no organization, and the purpose for which organized has been abandoned.

20. Dissolved. Where all the assets of a corporation have been distributed.

21. Sale. Where corporations have disposed of all their assets and property by sale to other corporations, firms, or individuals and business is no longer carried on under their charters.

22. Consolidated, merged or succeeded. Where corporations have terminated their existence as represented by these terms and it appears that no assets or property remain in the name of the retiring corporation.

23. No assets. Includes all corporations having no assets from which to submit an offer in compromise.

In cases not included in any of the above classes, the specific penalty will be asserted, and if the delinquency was not due to an intention to delay the administration of the law the minimum amount which will be accepted in compromise is as follows:

$5 in the case of an individual or withholding agent.
$10 in the case of a corporation, joint-stock company or association, or insurance company.

These amounts will be considered insufficient and will not be accepted in any case where it appears that a taxpayer was intentionally violating the provisions of law, and purposely delaying the filing of the returns. In all cases where revenue agents or other examining officers discover that any individual has an appreciable taxable income and the examining officer is of the opinion that the individual knew or should have known that he was required to make a return,

he should make a recommendation as to the minimum amount which should be accepted as an offer in compromise, and where the intent to evade tax is plain he should recommend prosecution. Special attention should be called to cases of individuals having a taxable income who have failed to file returns for a number of years.

In all cases of delinquency discovered by revenue agents and other examining officers, if the delinquency falls within a period for which the penalty can be asserted, such officers should secure from the delinquent a sworn statement setting forth the reason for delinquency. This statement should be attached to the return forwarded to the collector. The examining officer should state in his report the alleged reason for delinquency and if he is of the opinion that the minimum amount should not be accepted as an offer in compromise of liability to specific penalty, he should make a recommendation as to the minimum amount which should be accepted. Consideration will be given such recommendation by this office in accepting an offer in compromise. In forwarding offers in compromise on form 656 collectors should call attention to revenue agents' reports, if any, in which the non-acceptance of the minimum amount as an offer in compromise is recommended. The statement or affidavit attached to the return setting forth the reason for delinquency is not in lieu of the affidavit required to be attached to form 656. (Mim. Letter to Collectors No. 1675, November 3, 1917.)

Suits for penalties barred after 5 years.—Section 1047, Revised Statutes, in part, is as follows:

LAW. Section 1047 [Rev. Stat.]. No suit or prosecution for any penalty or forfeiture, pecuniary or otherwise, accruing under the laws of the United States, shall be maintained, except in cases where it is otherwise specially provided, unless the same is commenced within five years from the time when the penalty or forfeiture accrued. . . . .

Limitation on prosecution for criminal violations.—

LAW. Section 1321. (a) That the Act entitled "An Act to limit the time within which prosecutions may be instituted against persons charged with violating internal-revenue laws," approved July 5, 1884, is amended to read as follows:

"That no person shall be prosecuted, tried, or punished for any of the various offenses arising under the internal-revenue laws of the United States unless the indictment is found or the information instituted within three years next after the commission of the offense: *Provided,* That the time during which the person committing the offense is absent from the district wherein the same is committed shall not be taken as any part of the time limited by law for the commencement of such proceedings: *Provided further,* That the provisions

of this Act shall not apply to offenses committed prior to its passage: *Provided further,* That where a complaint shall be instituted before a commissioner of the United States within the period above limited, the time shall be extended until the discharge of the grand jury at its next session within the district: *And provided further,* That this Act shall not apply to offenses committed by officers of the United States."

(b) Any prosecution or proceeding under an indictment found or information instituted prior to the passage of this Act shall not be affected in any manner by this amendment, but such prosecution or proceeding shall be subject to the limitations imposed by law prior to the passage of this Act.

Compromise of penalty a bar to prosecution.—In a recent case[29] in which internal revenue officers, after defendant had admitted that he had not filed an income tax return as required by section 1004, accepted not only the tax but the penalty, informing defendant that such payment would end the matter and there would be no indictment, it was held that such acceptance and statement was a "compromise" within section 3229, Revised Statutes, and was a bar to prosecution.

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[29] *Rau v. U. S.*, 260 Fed. 131, 171 C. C. A. 167.

CHAPTER IX

RATES AND COMPUTATION OF TAX

The federal income tax has been in force ten years. In only four of the ten years have the rates stood without change. In the case of the 1921 law the last changes of rates and definition of income became effective January 1, 1922. This means that, in the absence of further changes, of which there is no present prospect, the computation of taxes will be relatively simple for all accounting periods ending after November 30, 1922.

Rates applicable to individuals.—The total rate applying to the income of individuals consists of two parts, the normal tax and the surtax. The normal tax is a flat rate of 8 per cent (reduced to 4 per cent upon the first $4,000 subject to normal tax).[1] The surtaxes begin to apply when the net income exceeds $6,000, and are rapidly progressive.[2]

The rates are applied to "net income" which is ascertained by subtracting specified "deductions" from "gross income," the latter being defined in the law to include the distributive shares of the profits of partnerships.[3] The terms "gross income" and "net income" are fully explained in Chapter XVI.

For the purposes of the normal tax only, further deductions are permitted under the title of "credits."[4] These credits

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[1] Citizens or residents of the United States entitled to the benefits of section 262 are subject to normal tax at the rate of 4 per cent on the first $4,000 of total net income from sources within the United States in excess of credits, and 8 per cent on the balance. See Chapter XLI.

[2] Section 211 (a-2). In 1921 the surtaxes began to apply at $5,000. [Section 211 (a-1).]

[3] Beginning with January 1, 1922, personal service corporations are taxed as ordinary corporations, the undistributed profits thereof not being taxed to the individual stockholders. [Section 218 (d).]

[4] See Chapter XV.

consist of dividends, interest on certain securities, and the personal exemptions.

Normal tax.—

LAW. Section 210. That, ... there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 8 per centum[5] of the amount of the net income in excess of the credits provided in section 216: *Provided,* That in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 4 per centum.[6]

Surtax.—The personal exemptions and other credits, such as dividends, are not recognized as deductions from the item of "net income" to which the surtaxes apply.[7]

The surtax rates for 1922, on incomes up to $100,000 are slightly less, and on incomes over $100,000 are considerably less, than those of 1921.

The rates which apply to each successive increment of income, the tax which results from the application of the rates to the increments, and the cumulation of these taxes, are set forth in the following table:

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[5] [Former Procedure] Earlier normal rates were as follows:

1913–1915.......	1 per cent
1916............	2 per cent
1917............	4 per cent, but only 2 per cent on the first $2,000
1918............	12 per cent, but only 6 per cent on the first $4,000
1919–1920.......	8 per cent, but only 4 per cent on the first $4,000

[6] See Chapter XV.

[7] See Chapter XV.

SURTAX RATES AND AMOUNTS OF SURTAXES PAYABLE IN 1922 AND SUBSEQUENT YEARS[8]

Net Income	Per Cent	Sur-tax	Total Cumulative Sur-tax*	Net Income	Per Cent	Sur-tax	Total Cumulative Sur-tax*
$ 6,000 to $10,000	1%	$ 40	$ 40	$58,000 to $60,000	27%	$540	$7,460
10,000 " 12,000	2	40	80	60,000 " 62,000	28	560	8,020
12,000 " 14,000	3	60	140	62,000 " 64,000	29	580	8,600
14,000 " 16,000	4	80	220	64,000 " 66,000	30	600	9,200
16,000 " 18,000	5	100	320	66,000 " 68,000	31	620	9,820
18,000 " 20,000	6	120	440	68,000 " 70,000	32	640	10,460
20,000 " 22,000	8	160	600	70,000 " 72,000	33	660	11,120
22,000 " 24,000	9	180	780	72,000 " 74,000	34	680	11,800
24,000 " 26,000	10	200	980	74,000 " 76,000	35	700	12,500
26,000 " 28,000	11	220	1,200	76,000 " 78,000	36	720	13,220
28,000 " 30,000	12	240	1,440	78,000 " 80,000	37	740	13,960
30,000 " 32,000	13	260	1,700	80,000 " 82,000	38	760	14,720
32,000 " 34,000	15	300	2,000	82,000 " 84,000	39	780	15,500
34,000 " 36,000	15	300	2,300	84,000 " 86,000	40	800	16,300
36,000 " 38,000	16	320	2,620	86,000 " 88,000	41	820	17,120
38,000 " 40,000	17	340	2,960	88,000 " 90,000	42	840	17,960
40,000 " 42,000	18	360	3,320	90,000 " 92,000	43	860	18,820
42,000 " 44,000	19	380	3,700	92,000 " 94,000	44	880	19,700
44,000 " 46,000	20	400	4,100	94,000 " 96,000	45	900	20,600
46,000 " 48,000	21	420	4,520	96,000 " 98,000	46	920	21,520
48,000 " 50,000	22	440	4,960	98,000 " 100,000	47	940	22,460
50,000 " 52,000	23	460	5,420	100,000 " 150,000	48	24,000	46,460
52,000 " 54,000	24	480	5,900	150,000 " 200,000	49	24,500	70,960
54,000 " 56,000	25	500	6,400	200,000 up	50	......	......
56,000 " 58,000	26	520	6,920				

*To ascertain the total tax payable, the normal tax of 8 per cent (reduced to 4 per cent on the first $4,000) must be applied to the total net income minus the credits and the result added to the figures given in this table.

The official directions for interpreting the foregoing table read as follows:

Regulation. . . . . The surtax for any amount of net income not shown in the above tables is computed by adding to the total surtax for the largest amount shown, which is less than the income, the surtax upon the excess over that amount at the rate indicated in the table. . . . . (Art. 12.)

For example, if the amount of net income is $63,128, the surtax is the sum of $8,020 (the surtax on $62,000, as shown by the table) plus 29 per cent of $1,128, or $327.12, making a total surtax of $8,347.12.

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[8] **[Former Procedure]** The surtax scales in force in previous years are shown in the table on the opposite page.

Capital net gains taxed at 12½ per cent.—Under the 1921 law,[9] gains from the sale or exchange of capital assets are taxed at 12½ per cent instead of at the higher rates when

Net Income	1918–1921 Per Cent	1917 Per Cent	1916 Per Cent	1913–1915 Per Cent
$5,000 to $6,000	1	1	..	..
6,000 " 7,500	2		..	..
7,500 " 8,000		2	..	..
8,000 " 10,000	3		..	..
10,000 " 12,000	4	3	..	..
12,000 " 12,500	5		..	..
12,500 " 14,000		4	..	..
14,000 " 15,000	6		..	..
15,000 " 16,000			..	..
16,000 " 18,000	7	5	..	..
18,000 " 20,000	8		..	..
20,000 " 22,000	9			
22,000 " 24,000	10			
24,000 " 26,000	11			
26,000 " 28,000	12			
28,000 " 30,000	13	8	1	
30,000 " 32,000	14			
32,000 " 34,000	15			
34,000 " 36,000	16			1
36,000 " 38,000	17			
38,000 " 40,000	18			
40,000 " 42,000	19			
42,000 " 44,000	20			
44,000 " 46,000	21			
46,000 " 48,000	22			
48,000 " 50,000	23	12	2	
50,000 " 52,000	24			
52,000 " 54,000	25			
54,000 " 56,000	26			
56,000 " 58,000	27			
58,000 " 60,000	28			
60,000 " 62,000	29			
62,000 " 64,000	30			2
64,000 " 66,000	31			
66,000 " 68,000	32			
68,000 " 70,000	33			
70,000 " 72,000	34	17	3	
72,000 " 74,000	35			
74,000 " 75,000	36			
75,000 " 76,000				
76,000 " 78,000	37			
78,000 " 80,000	38			
80,000 " 82,000	39			
82,000 " 84,000	40			
84,000 " 86,000	41			
86,000 " 88,000	42			3
88,000 " 90,000	43	22	4	
90,000 " 92,000	44			
92,000 " 94,000	45			
94,000 " 96,000	46			
96,000 " 98,000	47			
98,000 " 100,000	48			
100,000 " 150,000	52	27	5	
150,000 " 200,000	56	31	6	4
200,000 " 250,000	60	37	7	
250,000 " 300,000		42	8	5
300,000 " 500,000	63	46	9	
500,000 " 750,000	64	50	10	
750,000 " 1,000,000		55	10	
1,000,000 " 1,500,000		61	11	6
1,500,000 " 2,000,000	65	62	12	
2,000,000 up		63	13	

[9] Section 206.

the tax on net income is computed at the regular normal and surtax rates. For a full discussion of capital gains, capital deductions, and for illustrations of the necessary computations, see Chapter XXII.

Surtax on sale of mineral deposits.—

LAW. Section 211. . . . . **(b) In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this section attributable to such sale shall not exceed, ... 16 per centum, of the selling price of such property or interest.**[10]

REGULATION. Where the taxpayer by prospecting and locating claims, or by exploring and discovering undeveloped claims, has demonstrated the principal value of mines, oil or gas wells, which prior to his efforts had a relatively minor value, the portion of the surtax attributable to a sale of such property or of the taxpayer's interest therein shall not exceed . . . . 16 per cent of the selling price. Exploration work alone without discovery[11] is not sufficient to bring a case within this provision. Shares of stock in a corporation owning mines, oil or gas wells, do not constitute an interest in such property. To determine the application of this provision to a particular case the taxpayer should first compute the surtax in the ordinary way upon his net income, including his net income from any such sale. The proportion of the surtax indicated by the ratio which the taxpayer's net income from the sale of the property, or his interest therein computed as prescribed in article 715,[12] bears to his total net income is the portion of the surtax attributable to such sale, and if it exceeds[13] . . . . 16 per cent of the selling price of the property or interest, such portion of the surtax shall be reduced to that amount . . . . (Art. 13.)

If the taxpayer, however, has held the property for more than two years, he may elect to be taxed at a maximum rate of 12½ per cent under the capital gains provision.[14]

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[10] [Former Procedure] This rate, for the years 1918-1921, was 20 per cent.

[11] For definition of "discovery," see Chapter XXXVIII.

[12] The reference should be to article 714 of Regulations 62, which provides for the allocation of expenses directly where possible, and ratably where direct apportionment is not feasible. For illustration of computation of tax on profit from sale of oil well, etc., see *Excess Profits Tax Procedure,* 1921, pages 90-92.

[13] See footnote 10 above.

[14] Section 206, see Chapter XXII.

RULING. Where individuals transfer property to a corporation which later demonstrates the principal value of such property as oil-producing property "by prospecting or exploration and discovery work" and then dissolves, transferring the property to the individuals, who remain stockholders without change in interests, and such stockholders sell the property, the portion of the surtax attributable to such sale is not limited to 20 per cent[15] of the selling price of such property or interests under the provisions of section 211 (b). (C. B. 1, page 57; Digest T. B. R. 8.)

It is well to bear in mind that in computing the profit on the sale of oil wells the "discovery value" is not a factor. The "discovery" itself operates to give the seller the benefit of the 16 per cent tax. The "discovery value" is used only in computing the depletion allowance. Some confusion has arisen on this point in rulings handed down by the Committee on Appeals and Review and by the Advisory Tax Board, but the question was definitely settled in C. B. 3, page 44; Sol. Op. 26.

Rates applicable to corporations.—For 1922 and subsequent years the corporation income tax rate is 12½ per cent.

LAW. Section 230. That, ... there shall be levied, collected, and paid for each taxable year upon the net income of every corporaion a tax at the following rates:

(a) For the calendar year 1921,[16] 10 per centum of the amount of the net income in excess of the credits provided in section 236; and

(b) For each calendar year thereafter, 12½ per centum of the amount of the net income in excess of the credits provided in sections 236 and 264.[17]

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[15] Corresponds to the 16 per cent rate now in force.

[16] [Former Procedure] The 1913 rate on corporate incomes was identical with the normal rate on individual incomes, 1 per cent [section II, G (a)]. Again in the 1916 law it was identical at 2 per cent (section 10). In 1917, however, when an additional normal tax of 2 per cent was made to apply to individuals, the additional corporation rate was made 4 per cent (section 4), the total rate applying to corporations in 1917 being 6 per cent as compared with a total normal tax of 4 per cent on individuals. Corporations were permitted to take credit, in the case of dividends received, for only 4 per cent in place of 6 per cent, the 2 per cent difference operating as a penalty upon the corporate form. The rate for 1918 was fixed at 12 per cent, the same as the full normal rate on individuals, but for 1919 and 1920 it dropped to 10 per cent, while the individual rate for 1919 and 1920 dropped to 8 per cent. In 1921, when the individual rate was 8 per cent the corporation rate was 10 per cent.

For rates on transportation companies under government control, see *Income Tax Procedure,* 1921, page 154.

[17] Section 264 deals with China Trade Act and Corporations.

Although the limitation of tax on capital gains does not apply to corporations, no hardship is suffered by a corporation because the minimum tax under those provisions[18] in any event must amount to 12½ per cent, which is the rate imposed upon corporations.

Computation of the Tax in Special Cases

When special circumstances are present, the proper computation of the tax may be a complicated process.

Computation for fiscal years when rates or definition of income change.—A special computation is necessary whenever a fiscal year comprehends portions of calendar years during which different rates or different definitions of income were in force. Since the last changes prescribed by the 1921 law became effective on January 1, 1922, the computations prescribed in the law are of no interest, except as former procedure, to those filing returns for taxable years beginning on that date or later.

The plan laid down in the law for meeting the situation in 1921 and 1922 called for the computation of the taxes on the full income under the definitions and rates in force in each calendar year into which the fiscal period extended and a reduction of the amounts thus determined to correspond with the fraction of the respective calendar years covered by the fiscal period.[19]

Return for period of less than one year—placing income on annual basis.—The 1921 law provides that in the case of

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[18] See Chapter XXII.

[19] **[Former Procedure]** For the law covering this point see section 205. Full examples of the computation for individuals, partnerships, personal service corporations, and ordinary corporations will be found in *Income Tax Procedure*, 1922, pages 87-88, 163-166, 791-796, and 819-822.

A ruling specifically directed all corporations which had filed returns for a fiscal year ending in 1921 on the basis of the 1918 law to file new returns under the 1921 law. New returns were not required for partnerships. (C. B. I-1, page 291; I. T. 1277.) (See also T. D. 3310.)

returns for less than one year the tax is to be computed after the income has been placed on an annual basis.[20] This method, introduced for the first time in the 1921 law, tends to result in higher taxes for individuals.

LAW. Section 226. . . . . (c) In the case of a return for a period of less than one year the net income shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in such period; and the tax shall be such part of a tax computed on such annual basis as the number of months in such period is of twelve months.

INDIVIDUALS.—When an individual return is made for a period less than one year, the income is placed on an annual basis, and therefore the personal exemption and the credit for dependents are not reduced.[21] An individual reporting for, say, six months ending December 31, 1922, with net income for that period of $20,000, would compute his tax as follows:

	Income	Tax
Net income for six months	$20,000	
Placed on annual basis (20,000 x 12/6)	$40,000	
Less: Exemption (married, 3 children)	3,200	
	$36,800	
Taxable at 4 per cent	4,000	$ 160
Taxable at 8 per cent	$32,800	2,624
Surtax on $40,000 (1922 rates)		2,960
Total		$5,744
Tax payable, 6/12 of $5,744		$2,872

[20] [Former Procedure] Section 226 of the 1918 law provided for reduction of the personal exemption and credit for dependents.

1918 LAW. Section 226. . . . . the credits provided in subdivisions (c) and (d) of section 216, shall be reduced respectively to amounts which bear the same ratio to the full credits provided in such subdivisions as the number of months in such period bears to twelve months.

[21] [Former Procedure] The Treasury ruled that in cases where, under the 1918 law, a taxpayer was permitted to change his fiscal year and consequently had to report for a fraction of the year, both the normal tax and the surtax should be computed as though the return were filed for a full twelve-month period, after the reduction of the exemptions and credits provided in section 216 (c) and (d) of the Act. (C. B. 3, page 230; O. D. 723.)

Income for fractional parts of a year in case of the death of the taxpayer is to be placed on the annual basis:

Ruling. Under the provisions of section 226(c) of the Revenue Act of 1921, where a taxpayer dies on August 4, 1921, the decedent's income from January 1 to August 3, inclusive, should be multiplied by 12 and divided by 7.097 in order to place it upon an annual basis. The tax will be such part of a tax computed on such annual basis as 7.097 months is of 12 months. It follows that the income of the decedent's estate from August 4 to December 31, inclusive, should be multiplied by 12 and divided by 4.903 in order to place it upon an annual basis. (C. B. 1-1, page 243; Digest I. T. 1250.)

The decimal 7.097 is derived thus: January to August is 7 months; and the 3 days in August is 3/31 month, or .097 month. Hence the total period is 7.097/12 of a year.

The following ruling supports the position taken by the author that the income should be first placed on an annual basis before the personal exemption and credit for dependents are deducted.

Ruling. Reference is made to your letter of March 28, 1922, wherein you state the case of an individual, married and living with his wife and having a child fourteen years of age dependent upon him for support, who dies upon July 1. The decedent's accounting period is assumed to have been the calendar year, and for the six months' period from January 1 to June 30, inclusive, he is assumed to have had a net income of $4,000. You suggest a method of computation wherein the personal exemption and credit for dependents to which he is entitled under Section 216 (f) of the Revenue Act of 1921 is deducted from his income of $4,000 before the income is placed upon an annual basis in accordance with Section 226 (c) of the Act.

Your difficulty appears to have arisen from your failure to distinguish between "net income" and "net income subject to normal tax," and in this connection you are referred to Article 21 of Regulations 62. The personal exemption and credits for dependents do not diminish the net income of a taxpayer in any way. Section 212 (a) of the Revenue Act of 1921 provides: "That in the case of an individual the term 'net income' means the gross income as defined in section 213, less the deductions allowed by section 214."

Section 214 makes no provision for a personal exemption or for credits for dependents. Those are provided for by subdivisions (c) and (d) of Section 216 of the Act. When, therefore, Section 226 (c) directs that the net income for a fractional part of a year be

placed upon an annual basis no account should be taken of the personal exemption and credit for dependents prior to the placing of the net income upon an annual basis, but these should be credited against net income after it has been so placed upon an annual basis.

In the example stated, the correct method of computing the tax is as follows:

Net income for one-half year	$4,000.00
Net income raised to an annual basis	8,000.00
Personal exemption and credit for dependents	2,400.00
Amount subject to normal tax	$5,600.00
Amount subject to normal tax of 4%	4,000.00
Tax upon this amount	160.00
Amount subject to normal tax at 8%	1,600.00
Tax upon this amount	128.00
Surtax upon $8,000.00 at 1921 rates	50.00
Total normal tax and surtax upon income raised to an annual basis	338.00
Amount of tax payable upon income for one-half year	169.00

The personal exemption is reduced from $2,500 to $2,000 in accordance with Section 216 (c) because the net income placed upon an annual basis exceeds $5,000. (Letter to Prentice-Hall, Inc., signed by D. H. Blair, Commissioner, dated June 5, 1922.)

Reduction of the personal exemption as stated in the last paragraph of the foregoing ruling is not warranted. Section 216 (c) states that a married person living with husband or wife is entitled to "a personal exemption of $2,500, unless the *net income* is in excess of $5,000." Section 226 (c) provides: "In the case of a return for a period of less than one year the *net income* shall be placed on an annual basis. . . . ." In the instant case the "net income" was less than $5,000, so that the taxpayer is clearly entitled to the full $2,500 exemption. In ruling on a similar question involving a corporation the Treasury said: ". . . . the right to such credit is determined by the actual amount of the net income shown by the return and not by the amount which is disclosed when the net income is placed on an annual basis."[22]

RULINGS. (1). Reference is made to your letter of May 25, 1922, in which you request a reconsideration of the ruling of this office hold-

[22] I-36-493; I. T. 1439. See Chapter XV.

ing that Section 226 (c) of the Revenue Act of 1921 applies to the returns of decedents and estates of decedents covering a period of less than twelve months. In reply you are advised that careful consideration has been given to this question and the office finds nothing which would cause it to recede from or modify its former ruling. Accordingly, the income of decedents or of the estates of decedents covering a period of less than twelve months must be placed on an annual basis and the tax computed in accordance with Section 226 (c) of the Revenue Act of 1921. (Letter to Brower, Brower and Brower, Brooklyn, New York, signed by Deputy Commissioner E. H. Batson, and dated October 22, 1922.)

(2). Reference is made to your letter of April 21, 1922, presenting a proposed method for computing the income tax liability of a decedent who kept his books on a calendar year basis and was a member of a partnership which reported on the basis of a fiscal year ending July 31. In the case presented by you, the decedent died on January 31, 1922. You submit a method of computing his income tax liability whereby his distributive share of the net income of the partnership for the six months from August 1, 1921, to January 31, 1922, the date of decedent's death, and consequently the end of an accounting period of the partnership, is put on an annual basis by multiplying by 12 and dividing by 6. The decedent's income from other sources is put on an annual basis by multiplying by 12 and dividing by 1.

Section 226 (c) of the Revenue Act of 1921 provides as follows: "In the case of a return for a period of less than one year the net income shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in such period; and the tax shall be such part of a tax computed on such annual basis as the number of months in such period is of twelve months."

In the case under consideration the net income of the decedent for the taxable period from January 1 to January 31, 1922, must be computed from gross income that includes his distributive share of the net income of the partnership for the accounting period from August 1, 1921, to January 31, 1922, in accordance with the provisions of Section 218 (a) of the 1921 Act.

Section 226 (c) of the statute lays down a specific method of placing all the net income of a decedent on an annual basis and makes no provision for segregating any part of that income and using a different basis with respect to that part of the income. It is, therefore, held that in the instant case the method proposed by you of putting the decedent's distributive share of the net income of the partnership on an annual basis is not in accordance with the statute. (Letter to The Corporation Trust Company, signed by Commissioner D. H. Blair, and dated October 21, 1922.)

Dividends and interest to be placed on annual basis.—

Ruling. Do Section 226 subdivision C and Article 431 Regulations 62 apply to returns of decedent? Instruction 2, Form 1040 seems to indicate, apply only when accounting period changed. (Answer.) Section 226 (c) and Article 431 applicable to return for decedent.

If above apply, should net income be placed on annual basis by multiplying amount shown in item 19 by 12 and dividing by number of months or should each item of income and deductions be so placed on annual basis? If former, should not Items 21 (dividends) and 22 (taxable interest) be also placed on annual basis in figuring normal tax? (Answer.) Net income should be placed on annual basis by multiplying Item 19, Form 1040 by 12 and dividing by fractional part year covered by return. Items 21 and 22 should be accorded same treatment for purpose normal tax. (Telegram from Chadwick, McMicken, Ramsey & Rupp, Seattle, Washington, and reply thereto signed by Commissioner D. H. Blair, dated March 15, 1922.)

Corporations.—The calculation of the tax of a corporation for a period of less than twelve months and beginning after January 1, 1922,[23] would be as follows, if section 226 (c) quoted above were followed:

Net income (6 months)	$12,000	
Net income placed on an annual basis (12/6 × $12,000) [section 226 (c)]	$24,000	
Less: Specific exemption	2,000	
Subject to income tax	$22,000	at 12½%
Income tax	$2,750	
Tax for 6 months (½ of $2,750)	$1,375[24]	

However, the situation is complicated by the following section of the law, the inclusion of which is obviously due to an oversight:

Law. Section 239. . . . . **(b) Returns made under this section** [corporation returns] **shall be subject to the provisions of sections 226**

[23] The excess profits tax does not apply after this date.

[24] **[Former Procedure]** Under the 1918 law the tax was computed on the basis of the actual income for the period, the various credits being proportionately reduced. The actual result of the two methods should be the same. For examples of the calculations under the 1918 and 1921 laws when profits taxes are involved, see *Income Tax Procedure*, 1922, pages 167-169.

and 228. When return is made under section 226 [quoted above] the credit provided in subdivision (b) of section 236, [the $2,000 specific exemption] shall be reduced to an amount which bears the same ratio to the full credit therein provided as the number of months in the period for which such return is made bears to twelve months.

In an attempt to reconcile these sections the Treasury has ruled that:

REGULATION. . . . . This prorated credit shall be applied to the net income before such net income is placed on an annual basis, as provided in section 226 (c). . . . . (Art. 626.)

This results in the following rather superfluous computation:

The prorated credit mentioned in Article 626 above (½ of $2,000) is	$1,000
Deducting $1,000 from the net income $12,000, leaves subject to income tax	$11,000
Placing this amount on an annual basis (12/6 × $11,000)	$22,000
Income tax 10% of $22,000	$2,200
Income tax for 6 months (½ of $2,200)	$1,100

Placing the net income on an annual basis does not destroy the right a corporation may otherwise have to the proportionate part of the $2,000 exemption, even though as a result of such computation the net income exceeds $25,000.[25]

Reduction of personal exemption of individuals.—When the aggregate net income of husband and wife is in excess of $5,000, the personal exemption is reduced from $2,500 to $2,000. But the law provides:

LAW. Section 216. . . . . (c) . . . . In no case shall the reduction of the personal exemption from $2,500 to $2,000 operate to increase the tax, which would be payable if the exemption were $2,500, by more than the amount of the net income in excess of $5,000.

For an illustration of the necessary computations, see Chapter XV.

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[25] See Chapter XV.

When the specific credit of $2,000 is not allowed a corporation.—If the net income of a corporation is greater than $25,000, the specific credit of $2,000 is not allowed. But the law provides:

LAW. Section 236. . . . . (b) . . . . if the net income is more than $25,000 the tax imposed by section 230 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000; and . . . .

The $2,000 exemption is allowed even though the net income when placed on an annual basis exceeds $25,000. See Chapter XV.

Fractional part of a cent not to be disregarded in computation of tax.—

REGULATION. In the payment of taxes a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to one cent. Fractional parts of a cent should not be disregarded in the computation of taxes. (Reg. 45, Art. 1721.)

Fractional part of month—how computed.—

RULING. Paragraph 10, page 1, of the instructions attached to Form 1120 for 1921, to the effect that if the period for which a first or final return is made includes fractions of months there shall be added to the number of complete months as many thirtieths of a month as there are days in the fractional part of months, should be followed for such purposes only in cases where the fractional months have 30 days. (I-35-485; I. T. 1433.)

CHAPTER X

ORGANIZATION AND ADMINISTRATION

The administration of the Revenue Act is placed in the hands of the Commissioner of Internal Revenue, referred to in this book as the "Commissioner," subject to the general supervision and control of the Secretary of the Treasury.

Bureau of Internal Revenue.—The Bureau of Internal Revenue, referred to in this book as the "Bureau," as its name implies, is charged with the collection of all federal revenue other than customs. There are five deputy commissioners[1] and one Assistant Commissioner, who is authorized to act in the Commissioner's place. Income and excess profits taxes are collected through the local collectors of internal revenue, who are also charged with the collection of all other internal revenue taxes. The collectors of internal revenue are the officers who come into the most direct touch with the taxpayers and they are held primarily responsible for the proper collection of the tax in their districts. At present there are some sixty-four collection districts, each with a collector at its head assisted by a staff of subordinates. In addition there are thirty-five internal revenue divisions with internal revenue agents or supervising internal revenue agents in charge.

Procedure of the Bureau of Internal Revenue.—The steps in the procedure of the Bureau of Internal Revenue have been described as follows:[2]

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[1] The deputies are in charge of the following: 1. Income Tax Unit; 2. Estate and Capital Stock Tax Unit; 3. Sales Tax Unit; 4. Accounts and Collections Unit; 5. Miscellaneous (publications, administration, etc.)

[2] A. E. James, *Bulletin of National Tax Association,* Vol. VI, page 49.

1. The taxpayer makes a return and pays to the collector, who receives the return, one-fourth or all the tax shown due on the face of the return.

2. The collector lists the returns, shows the taxes due, makes a few obvious corrections in some cases and forwards the returns to Washington.[3]

3. In Washington the returns are first checked against the collector's lists and the original tax verified.

4. The "audit" of the returns begins and supplemental amounts of taxes due [and the amount of overpayments] are determined; the taxpayer is notified and, [after the procedure laid down in section 250 (d) has been complied with], the return is sent to a separate section of the Bureau for entry on a supplemental list.[4]

5. Supplemental lists are transmitted monthly to the collectors, the taxpayer is formally notified [of additional taxes] and the tax is due for payment within ten days after such notice.

Committee on Appeals and Review.—Under the 1918 law[5] the Commissioner was empowered to appoint an Advisory Tax Board.[6] The Board was appointed March 14, 1919, and abolished October 1, 1919. This Board performed a difficult and thankless task in an energetic and equitable manner. It decided almost insoluble problems and retained the respect and earned the gratitude of taxpayers even though it did not always give them what they wanted.

If we are ever able to evolve an organization which will enlist the active assistance of a considerable number of the best business and professional men of the country it probably will be necessary to make an arrangement whereby they will

[3] Returns on form 1040A are not sent to Washington, but are audited in the collectors' offices.

[4] If it is found that there has beeen an overpayment of tax, the taxpayer is sent a certificate of overassessment which enables an adjustment to be made by the local collector.

[5] Section 1301 (d-1).

[6] For a full discussion of its powers and procedure see *Income Tax Procedure*, 1920, pages 159-161.

give their services for only a small part of each year. The sacrifice involved in accepting a full-time appointment is too great. The British Board of Referees decides many different problems for the British Treasury without calling upon its members for more than two weeks of service a year.

In the place of the Board, a Committee on Appeals and Review was established, the membership of which has been recruited from within the Bureau.

Organization.—The Committee[7] is entirely independent of the Income Tax Unit and in theory is responsible only to the Commissioner. Its personnel embraces a chairman, vice-chairman, eleven members, and a secretary, who give their entire time and attention to all matters referred to the Committee for consideration. All of the members have held responsible positions in the Bureau as heads of divisions or chiefs of sections and are either attorneys at law or accountants.

There is some evidence of a decline in the independence and power of the Committee. There is a tendency to have the Solicitor review all the decisions of the Committee. It is also understood that the Assistant Commissioner is gradually building up a staff of experts about him who also review the Committee's decisions. Reviews such as these destroy the effect of an appeal. Neither the Solicitor nor the representatives from the Commissioner's office attend the hearings. The author has no objection to the Commissioner's being fully represented and securing advice from the Solicitor. The author would suggest, however, that a member of the Solicitor's office attend each hearing of the Committee to help develop the case. As has been pointed out in this book for several years,

[7] At the present time, the Committee is composed of the following: N. T. Johnson, Chairman; G. R. Davis, Vice-Chairman; A. W. Gaumer; Leslie Gillis; C. P. Hoffman; W. R. King; W. H. Lawder; C. P. McGinley; L. R. Russell; R. J. Service; C. P. Smith (formerly Assistant Commissioner); R. G. Stetson; M. E. Stickley and F. G. Smith, Secretary. In order to expedite the settlement of 1917 cases by March 1, 1923, a special committee, consisting of F. B. Bell; A. C. Muddiman; A. W. Gregg; C. D. Hamel and B. M. Price, has been appointed to assist the Committee on Appeals and Review.

the procedure before the Committee, as well as that before the conferees of the Unit, places the representative of the government in the position of both prosecutor and judge.

The law provides that a taxpayer shall have the right of appeal, and it also states an "opportunity for hearing shall be granted." As the Commissioner has designated the Committee on Appeals and Review to act for him, it should in fact decide the case and no review should be made without giving the taxpayer the privilege of being present.

The Committee on the whole has done good work, and has earned the confidence of taxpayers. It is to be hoped that it will be strengthened and not weakened. Unless taxpayers can be made to feel that they are presenting their arguments to those who have the authority and courage to render final decisions, the so-called Committee on Appeals and Review, purportedly acting for the Commissioner, will degenerate into another investigating body with little discretion and less prestige. The inevitable result will be that all important decisions against taxpayers will be carried to the courts on the ground that no argument was heard by anyone having the power to decide.

Procedure.—The principal duties of the Committee are as follows:

1. Hearing and consideration of cases appealed by taxpayers from the action of the Income Tax Unit;
2. Consideration of questions submitted by the Income Tax Unit with the request for the Committee's advice;
3. Criticism or approval of letters making new rulings or new applications of old rulings which are submitted by the Income Tax Unit or the Commissioner;
4. Criticism or approval of proposed Treasury decisions;
5. Consideration of matters presented in informal conferences by officers of the Bureau and by taxpayers upon questions of interpretation, policy, or procedure.

Cases may be appealed to the Committee only after final disposition has been made of the case by the Income Tax Unit, and upon such questions, either as to the law or the facts, as are in controversy between the taxpayer and the Income Tax Unit.[8]

The following ruling outlines the procedure in hearings before the Committee:

RULING. When an appeal is taken from a ruling of the Income Tax Unit to the Committee on Appeals and Review or a question is certified to that Committee at the request of the taxpayer and an oral presentation is desired, the record shall immediately be examined to ascertain as to whether there is a question of law involved. If it is found that a question of law is involved, the Solicitor shall be notified and he will thereupon designate one member of the Solicitor's office to sit with the Committee and himself for the purpose of hearing the appeal, or if the Solicitor finds it inconvenient to sit with the Committee he may designate two members of his office to do so.[9]

At the hearing before the Committee the taxpayer or his attorney or representative will be expected to make his full oral argument on the law as well as the facts, and this presentation shall be the only oral presentation except in unusual circumstances, or unless a further argument of the facts or the law is deemed desirable by either the Chairman of the Committee or the Solicitor.

The attorney or attorneys so designated by the Solicitor for the hearing will be expected, in conjunction with the Solicitor and the Conference Committee in the Solicitor's office, if the Solicitor so desires, to consider the legal aspects of the case, and the Solicitor's recommendation in the form of an opinion or memorandum will then be made to the Chairman of the Committee, and thereupon the Committee's findings shall be prepared and submitted to the Commissioner for his approval. . . . . (C. B. 3, page 370; O. D. 709.)

The appeal and all related papers are transmitted to the Committee on Appeals and Review and are docketed for assignment to a member for consideration.

Upon assignment of the case the papers are carefully examined and in the event that additional information is desired

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[8] Prior to the 1921 law, it was contrary to the policy of the Bureau to defer assessments pending the taking up of an appeal. This was an unjust rule, which is now, in most cases, abolished by section 250 (d) of the 1921 law. See page 211.

[9] As a general rule, the auditor who has handled the case also attends the conferences of the Committee.

or an oral hearing has been requested or is deemed advisable, the taxpayer is notified.

In the event of an oral hearing, which will presumably be final, the taxpayer is expected to submit such arguments and presentation both as to the law and the facts as he desires to have considered by the Bureau. The oral hearing may be supplemented by a written brief to be submitted after the hearing. Three copies of this brief should be furnished.

The conclusions of the individual members of the Committee, after being formulated and reduced to writing, are submitted to a conference of the entire Committee and, when agreed to, are submitted to the Commissioner in the form of recommendations.

Upon the approval of the Committee's recommendation by the Commissioner, the decision is final as far as the Bureau is concerned, and the decision will not be reconsidered except upon the presentation of new and material evidence, accompanied by an explanation satisfactory to the Committee of the failure to produce such evidence prior to the closing of the case.[10]

The taxpayer is notified by the Committee of its recommendation and the case and related papers are thereupon returned to the Income Tax Unit for such further action as may be necessary in accordance with the decision of the Committee of which action the taxpayer is duly notified by the Income Tax Unit.

Regulations governing practice before the Treasury.— The Commissioner has issued regulations (Department Circular No. 230, Revised April 25, 1922, Form 23)[11] governing the recognition of attorneys and agents and other persons representing taxpayers before the Treasury. The following extracts are of interest:

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[10] See page 238.

[11] C. B. I-1, page 469. This circular supersedes Treasury Department Circular No. 230 (C. B. 4, pages 408-414), dated February 15, 1921, as amended June 7, 1921, July 1, 1921, and December 23, 1921.

2. *Applications for enrollment.*—Applicants for enrollment pursuant to these regulations shall submit to the Secretary of the Treasury an application, properly executed, on Form 23, attached hereto. Applications in any other form will not be considered. The statements contained in the application must be verified by the applicant. The applicant must also take the oath of allegiance, and to support the Constitution of the United States as required by section 3478, Revised Statutes. A person who can not take the oath of allegiance, and to support the Constitution of the United States can not be enrolled. Members of the bar of a court of record will apply for enrollment as attorneys; all others will apply for enrollment as agents. The Secretary of the Treasury may in any case require other and further evidence of qualification. Applicants will be notified of the approval or disapproval of their applications. All applications for enrollment must be individual, and individuals who practice as partners should apply for enrollment as individuals and not in the partnership name. An individual who has been enrolled may, however, represent claimants and others before the Treasury Department in the name of a partnership of which he is a member or with which he is otherwise regularly connected. Except as hereinafter provided in paragraph 3, a corporation can not be enrolled and attorneys or agents will not be permitted to practice before the Treasury Department for account of a corporation which represents claimants and others in the prosecution of business before the Treasury Department. Persons applying for enrollment who propose to act for such a corporation in the prosecution of claims and other business before the Treasury Department, will be subject to rejection, and enrolled attorneys or agents who act for a corporation in representing claimants and others in the prosecution of claims and other business will be subject to suspension from practice, as to such claims or business.

. . . .

4. *Restriction of right to be heard to parties and enrolled attorneys and agents.*—(*a*) The committee on enrollment and disbarment shall maintain in the office of the chief clerk, Treasury Department, a roll of attorneys and agents entitled to practice before the Treasury Department. It shall likewise maintain lists of those whose applications for enrollment have been rejected and those who have been suspended or disbarred. The chief clerk shall furnish copies of said roll and lists, with such additions thereto or subtractions therefrom as may be made from time to time, to the several bureaus, offices and divisions of the Treasury Department, and upon request may furnish information as to whether or not any person is enrolled as an attorney or agent before the Treasury Department.

(*b*) All bureaus, offices and divisions of the Treasury Department are hereby prohibited from recognizing or dealing with anyone appearing as attorney or agent unless the name of such attorney or

agent appears upon the list of those entitled to practice before the Treasury Department, provided, however, that the head of any bureau, office or division may, in his discretion, temporarily recognize such representative pending action upon his application for enrollment, provided his name does not appear on the list of those whose applications for enrollment have been rejected or on the list of those who have been suspended or disbarred. It shall be the duty of the several bureaus, offices and divisions of the Treasury Department to ascertain in each case whether the name of one appearing before them in a representative capacity appears on the roll of those entitled to practice, whether such representative has been suspended or disbarred, and whether he is ineligible under section (*c*) of this paragraph or under section 190 of the Revised Statutes. Nothing herein contained shall preclude individual parties or members of firms, or officers of corporations, or authorized employees of firms or corporations, from appearing, upon proper identification, as representatives of their own interests or of their respective firms or corporations in any matter before the department in which such person, firm or corporation is concerned as a principal; but attorneys, counsel, solicitors, accountants and other agents for such persons, firms or corporations must be enrolled.

(*c*) No attorney or agent shall be permitted to appear in a representative capacity before the Treasury Department, or any of the bureaus, offices, units, divisions, subdivisions, or other agencies thereof, in regard to any claim, application for reaudit, refund, abatement or reduction in tax assessed, or any other matter, to which he gave actual personal consideration, or as to the facts of which he had actual personal knowledge, while in the service of the Treasury Department.

The foregoing regulation is in addition to the inhibition contained in section 190 of the Revised Statutes of the United States, and does not authorize the appearance of an attorney or agent in the prosecution of any claim that would be prohibited by that section.

. . . .

6. *Causes for rejection, suspension or disbarment.*—(*a*) The Secretary of the Treasury may, as herein provided, suspend or disbar any enrolled attorney or agent shown to be incompetent or disreputable, or who refuses to comply with these rules and regulations, or who shall with intent to defraud, in any manner willfully and knowingly deceive, mislead, or threaten any claimant or prospective claimant, by word, circular or letter, or by advertisement. It shall be the duty of every attorney and agent to use the utmost diligence in furnishing evidence required in matters presented to the Treasury Department, and the use of any means whereby the final settlement of a claim or other business pending before the Treasury Department is unjustifiably delayed may be sufficient cause for suspension or disbarment. If any

enrolled attorney or agent shall knowingly employ as correspondent or subagent in any matter pending before the Treasury Department a person who is at the time denied enrollment, or suspended or disbarred from practice before the department, such attorney or agent himself may be suspended or disbarred.

(*b*) Advertising by enrolled attorneys or agents which describes their capacity or ability to render service as enrolled attorneys or agents is forbidden. Letterheads, business cards, and insertions in directories, newspapers, trade journals, or other publications should set forth only the name and address of the attorney or agent and a brief description of his practice. The description should not do more than state the nature of the attorney's or agent's business, that is to say, whether he practices as an attorney, accountant or agent, and, if desired, any special field of service or practice covered. The use by attorneys, agents, or others of adjectives or other terms which might imply official capacity or connection with the Government or any of its departments, is specifically forbidden.

(*c*) The solicitation of claims or other business as attorney or agent for others before the Treasury Department by circulars, advertisements, or other means, including personal letters, communications, or interviews not warranted by previous business or personal relations with the persons addressed, is forbidden. *Advertising or solicitation which makes any suggestion of previous connection with the Treasury Department or acquaintance with its officials or employees, or any reference to the fact of enrollment, is specifically forbidden.*

(*d*) Statements or implications to the effect that an attorney or agent is in position by reason of past experience, past official connection, or personal association with the Treasury Department or any officials or employees thereof, directly or indirectly to influence the disposition of business in the Treasury Department, and statements or implications to the effect that the agent or attorney is able to obtain information or consideration that is not available to the public in regard to such business, are forbidden.

(*e*) While contingent fees may be proper in some cases before the department, they are not generally looked upon with favor and may be made the ground of suspension or disbarment. Both their reasonableness in view of the services rendered and all the attendant circumstances are a proper subject of inquiry by the department. The Commissioner of Internal Revenue or the head of any other Treasury bureau or division of the Secretary's office may at any stage of a pending proceeding require an attorney or agent to make full disclosure as to what inducements, if any, were held out by him to procure his employment and whether the business is being handled on a contingent basis, and, if so, the arrangement regarding compensation.

(*f*) Violation of any of the foregoing regulations is declared

cause for suspension or disbarment of any attorney or agent enrolled to practice before the Treasury Department, while violation thereof by any person applying for enrollment as attorney or agent will be cause for rejection of his application.

These regulations tend to raise the standard of the practice before the Treasury and should be encouraged.

Power of attorney must comply with certain requirements.—

Ruling. . . . . Any power of attorney offered in evidence in any case will be accepted only provided it is in regular form. It is considered necessary in the case of an individual that the power of attorney be signed by the taxpayer, contain language to convey his intention, not necessarily in strictly legal form, and be attested before a notary public or be witnessed before two disinterested individuals. In the case of a partnership, a power of attorney must be signed by all members of the partnership and properly sworn to or witnessed as above. In the case of a corporation, it must be signed by an officer of the corporation, attested by the secretary under the seal of the corporation and executed before a notary or attested as above. Under no circumstances shall a power of attorney which does not have attached to it a revenue stamp in the amount of 25 cents be accepted. . . . . (C. B. I-1, page 419; Misc.)

The author suggests the use of a form similar to the following:

POWER OF ATTORNEY

To the Commissioner of Internal Revenue,
Washington, D. C.

Sir:

Mr....................., or/and Mr....................., is authorized to represent.. in connection with all tax returns which have been filed by this company with any department of the United States Government. The said representatives are authorized to act for it and in its name, place and stead. This letter will serve as written authority authorizing him to examine and secure copies of all returns, claims, correspondence and papers in connection therewith. This letter will also serve as written authority authorizing him to receive any warrants which may be issued in its name. We hereby specifically authorize the above mentioned representatives to secure, if necessary, copies of any income or excess profits tax returns heretofore filed by us.

The said representatives are vested with full Power of Substitu-

tion and Revocation. The execution of this instrument hereby ratifies and confirms all that said representatives shall lawfully do or cause to be done, by virtue hereof.

Respectfully,

(AFFIX CORPORATE SEAL) ....
(Name of Corporation)

ATTEST: BY.............................
(Signature and Title of Office)

....
Secretary

Personally appeared before me, a Notary Public of the State of............, County of............ on......................, 192—, ..., who, being duly sworn according to law and having signed the foregoing in my presence, stated that he is........................
(Title)

of ...., and that he executed
(Name of Corporation)

the foregoing power of attorney by virtue of the power vested in him by this corporation.

....
Notary Public

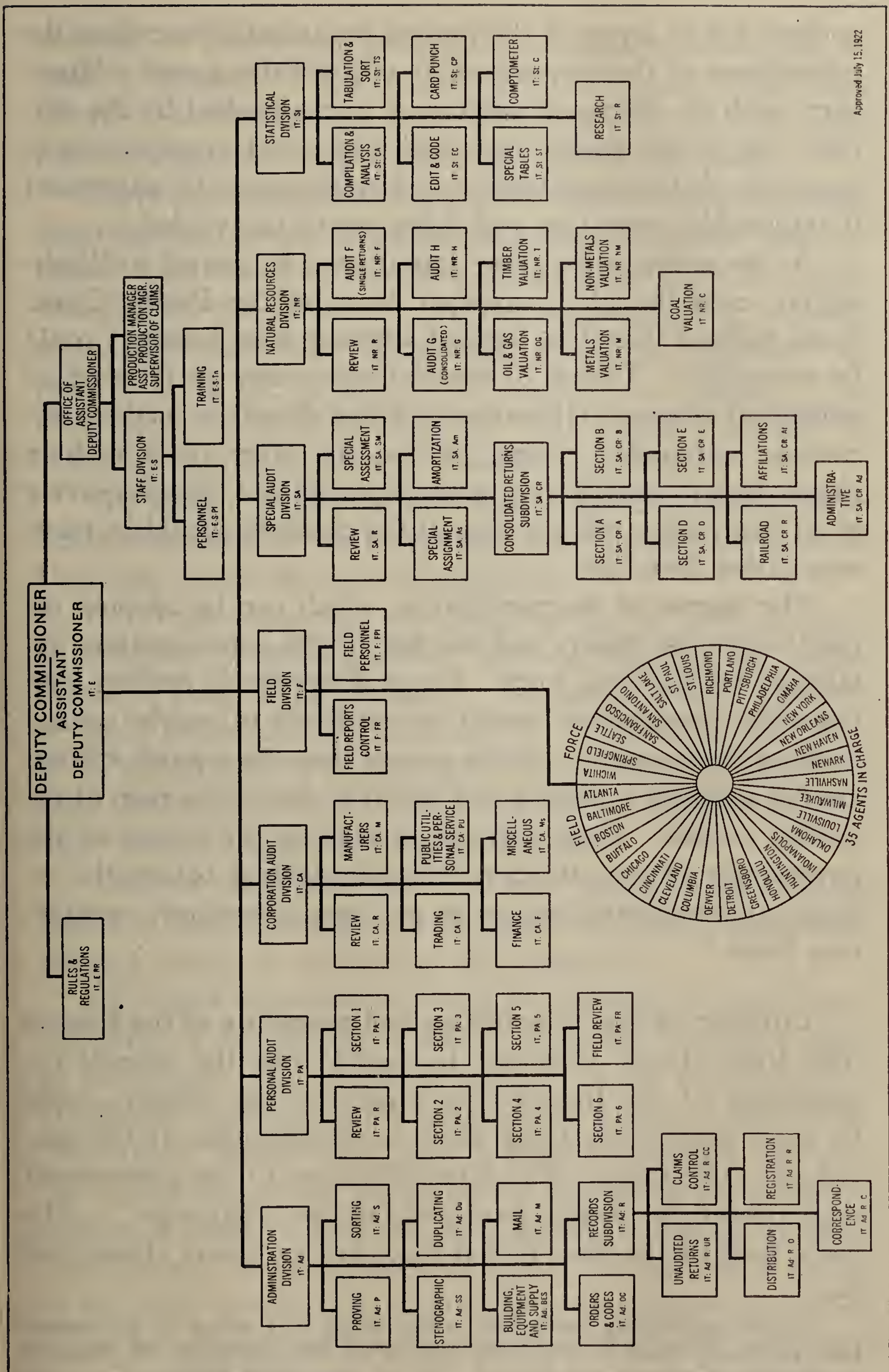
(AFFIX NOTARIAL SEAL)

Organization of Income Tax Unit.—Those who have dealings with the Bureau will be interested in the organization of the Income Tax Unit, as set forth in the chart reproduced on page 193. Changes are being made from time to time, but the chart is recent enough to be of interest.[12]

The Committee on Appeals and Review is entirely independent of the Income Tax Unit and in theory is responsible only to the Commissioner.

Bureau is overcentralized.—Criticism may be urged against the general organization of the Bureau of Internal Revenue on the ground of overcentralization. At present only the most routine matters can be handled in the offices of the local collectors, all others being carried to Washington for consideration. Uniformity of procedure is, of course, im-

[12] The chart reproduced was approved July 15, 1922.


DEPUTY COMMISSIONER
ASSISTANT DEPUTY COMMISSIONER
IT: E
RULES & REGULATIONS IT E RR
OFFICE OF ASSISTANT DEPUTY COMMISSIONER
PRODUCTION MANAGER
ASST PRODUCTION MGR.
SUPERVISOR OF CLAIMS
STAFF DIVISION IT: E S
TRAINING IT E S Tn
PERSONNEL IT: E S Pl
STATISTICAL DIVISION IT: St
COMPILATION & ANALYSIS IT: St: CA
TABULATION & SORT IT: St: TS
EDIT & CODE IT St EC
CARD PUNCH IT: St: CP
SPECIAL TABLES IT St ST
COMPTOMETER IT: St: C
RESEARCH IT St R
NATURAL RESOURCES DIVISION IT: NR
REVIEW IT NR R
AUDIT F (SINGLE RETURNS) IT: NR: F
AUDIT G (CONSOLIDATED) IT: NR: G
AUDIT H IT: NR H
OIL & GAS VALUATION IT: NR OG
TIMBER VALUATION IT: NR: T
METALS VALUATION IT: NR M
NON-METALS VALUATION IT: NR NM
COAL VALUATION IT: NR: C
SPECIAL AUDIT DIVISION IT: SA
REVIEW IT: SA: R
SPECIAL ASSESSMENT IT: SA: SM
SPECIAL ASSIGNMENT IT: SA: As
AMORTIZATION IT: SA: Am
CONSOLIDATED RETURNS SUBDIVISION IT: SA: CR
SECTION A IT: SA: CR: A
SECTION B IT: SA: CR: B
SECTION D IT SA CR D
SECTION E IT SA CR E
RAILROAD IT SA CR R
AFFILIATIONS IT: SA: CR: Af
ADMINISTRATIVE IT SA CR Ad
FIELD DIVISION IT: F
FIELD REPORTS CONTROL IT: F: FR
FIELD PERSONNEL IT: F: FPl
FIELD FORCE
35 AGENTS IN CHARGE
ST. PAUL
ST. LOUIS
RICHMOND
PORTLAND
PITTSBURGH
PHILADELPHIA
OMAHA
NEW YORK
NEW ORLEANS
NEW HAVEN
NEWARK
NASHVILLE
MILWAUKEE
LOUISVILLE
OKLAHOMA
INDIANAPOLIS
HUNTINGTON
HONOLULU
GREENSBORO
DETROIT
DENVER
COLUMBIA
CLEVELAND
CINCINNATI
CHICAGO
BUFFALO
BOSTON
BALTIMORE
ATLANTA
WICHITA
SPRINGFIELD
SEATTLE
SAN FRANCISCO
SAN ANTONIO
SALT LAKE
CORPORATION AUDIT DIVISION IT: CA
REVIEW IT: CA: R
MANUFACTURERS IT: CA: M
TRADING IT: CA T
PUBLIC UTILITIES & PERSONAL SERVICE IT: CA: PU
FINANCE IT: CA: F
MISCELLANEOUS IT: CA: Ms
PERSONAL AUDIT DIVISION IT: PA
REVIEW IT: PA R
SECTION 1 IT: PA: 1
SECTION 2 IT: PA: 2
SECTION 3 IT: PA: 3
SECTION 4 IT: PA: 4
SECTION 5 IT: PA: 5
SECTION 6 IT: PA: 6
FIELD REVIEW IT: PA: FR
ADMINISTRATION DIVISION IT: Ad
PROVING IT: Ad: P
SORTING IT: Ad: S
STENOGRAPHIC IT: Ad: SS
DUPLICATING IT: Ad: Du
BUILDING, EQUIPMENT AND SUPPLY IT: Ad: BES
MAIL IT: Ad: M
ORDERS & CODES IT: Ad: OC
RECORDS SUBDIVISION IT: Ad: R
UNAUDITED RETURNS IT: Ad: R: UR
CLAIMS CONTROL IT: Ad: R: CC
DISTRIBUTION IT: Ad: R: D
REGISTRATION IT Ad R R
CORRESPONDENCE IT Ad R C
Approved July 15, 1922

portant, but to secure it the present organization sacrifices the convenience of the taxpayer to an unjustifiable extent. Moreover, with the increased volume of work handled by the Bureau, due to the greatly increased number of taxpayers, it is important that decentralization in administration be introduced if intolerable congestion and delay are to be avoided.

At the present time every appeal must be carried to Washington, even though a taxpayer lives on the Pacific Coast. Some method should be devised whereby local hearings could be arranged.[13] This is of especial importance in the case of individual returns. Of course no effort should be made to encourage unfounded claims, but on the other hand nothing should be left undone to give an impartial and patient hearing to all just claims, and the way of the claimant should be made easy rather than hard.

The degree of decentralization which can be adopted depends upon the quality and number of the administrators obtainable for the local work. Large discretion in dealing with important assessments cannot be entrusted to poorly trained or ignorant assessors. At the present time the rewards offered are not sufficient to attract and retain in the service men of the quality needed. Some method of making the career of the government officer attractive must be devised before the income tax administration can be put upon an entirely satisfactory basis.

Criticism of the organization and procedure of the Income Tax Unit.—Little fault can be found with the general organization of the Income Tax Unit. A few changes could be made in order to bring about a simplification of the procedure. The Income Tax Unit, like most of the government departments, is bound hard-and-fast by "red tape." The chief fault of the Unit is that there are too many checks and

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[13] Such opportunity was given by the act of 1894, which in this matter took particular pains to make the remedy as inexpensive to the taxpayer as possible (*Congressional Record, Vol.* 25, pages 6828-6830).

reviews. There are so many that the author is not able to state the number. They not only add to the cost of collection, but they cause confusion and irritation among taxpayers, and tend to destroy the initiative of the Unit's employees.

There can be no question about the vital necessity of enough supervision to detect fraud on the part of taxpayers and collusion of one kind or another. It would certainly be highly desirable for the Bureau to stop the leaks regarding proposed assessments and other information which so frequently appear to be in the possession of so-called tax experts. The connections of each ex-employee who practices before the Treasury require even more careful inspection.

The author makes the following suggestion which he believes will simplify the procedure, speed up the work of the Unit and reduce the cost of collection.

Up to the issuance of the assessment letter, which is based either upon an office audit or field examination, no change should be made in the procedure. Precaution should, however, be taken to see that the conferees do not actively participate in the preparation of the assessment letter, i.e., they should not make decisions on a point in a case which should disqualify them when the taxpayer presents his case.

After an assessment letter has been issued, if the taxpayer makes a protest against the proposed additional assessment, the case should be referred to the conferees.

All formal conferences should be attended by three representatives of the Bureau: a lawyer, from the Solicitor's office, an accountant, who should be attached to the particular subdivision or section which is handling the case, and an auditor. The lawyer should pass upon the legal points of the case. The accountant should handle all the accounting problems and dispose of them. These two men should co-operate, as many points have to be passed upon by both. The auditor, in charge of the audit of the case, should attend the conference merely to be in a better position to carry out the decisions of the two conferees.

The regulation requiring the filing of a brief (in duplicate and supported by an affidavit of the taxpayer) at least five days before the date for the conference is a good rule and should not be changed. When a taxpayer does not request a formal conference, a brief in duplicate and in affidavit form should be filed before the case is considered by the conferees. When there are no formal conferences, the three representatives should meet and consider the case as though a formal conference were held.

After a case has been heard and the conferees are convinced that all the facts have been developed, a decision should be announced on all the points involved. This decision should not, however, be announced in conference. A letter should be sent the taxpayer notifying him of the results. This letter would furnish the Bureau auditor with instructions on which to close the case finally.

The procedure of these conferees should correspond with the procedure of a lower court. The chiefs of the sections should have no control whatever over the decisions. The chief should, however, control the assignment of cases for decision. It might be well for each subdivision or section to have a committee of conferees to which cases ready for attention would be assigned. A head conferee should take care of the assignments. It might even be desirable to make the conferees an independent organization.

Either the government or the taxpayer could appeal from the decision of the conferees to the Committee on Appeals and Review.

The appeal on the part of the government would be made by the Chief of the subdivision or section if he were not satisfied with the ruling. He should, of course, in every case review the decision of the conferees. He should also consult freely with the auditor. Notice of appeal should be required within, say, thirty days after the decision was announced. Claims should be handled in the same manner.

Under present procedure many of the conferences and

decisions of conferees are farces. Review bodies are permitted to review decisions, and to reverse them without notifying the taxpayer. The taxpayer is not notified of the appeal within the Bureau, hence he is not allowed to appear to present his case. The reviewers do not attend conferences, hence do not hear the oral arguments. The entire procedure partakes too much of "star chamber" methods.

Administrative interpretation.—Pending the construction of the statutes by the courts and subject, of course, to such construction, the Treasury is called upon to supply an official interpretation of the law for the guidance of taxpayers.[14] Until the statutes are completely adjudicated, disagreements may always be expected between taxpayers and the Treasury regarding the meaning of the law; for, as a matter of policy, the Treasury interprets the law in a strict and narrow fashion. There are large sums continually involved in disputes turning upon close constructions of the law and taxpayers cannot assume that their interests will be adequately protected by blind conformity with the Treasury rulings. Indeed the system rests upon the assumption that they will not follow the rulings blindly, but will rather contest doubtful points which operate to their disadvantage. This throws a heavy burden upon the taxpayer—one which in some cases is essentially unjust. Especially in the case of minor points which involve relatively small sums, the Treasury should make a reasonably liberal interpretation of the law at the very beginning, because a taxpayer will not contest a trifling matter, but will smart bitterly if he feels that the Treasury has imposed upon him. Common sense and reasonableness in the interpretation of doubtful points are essential to successful administration of the law.

In recent regulations there has been evident a very commendable effort to make the interpretation as general and illuminating as possible. Regulations 45 and 62 are superior to their predecessors, Regulations 33 and Regulations 41. In-

[14] For description of official publications see page 25.

stead of restricting itself to the treatment of a very narrow, particular instance, the Treasury has in most cases essayed a comprehensive treatment of the problem of procedure involved and has not hesitated to enunciate general principles which are to serve as official guides to action by taxpayers.

LEGAL FORCE AND EFFECT OF TREASURY INTERPRETATIONS.[15]—It must always be remembered, however, that the Supreme Court of the United States is the "last word" on income tax questions—not the Treasury through its regulations and decisions, nor even Congress on all points. Many acts of Congress dealing with taxation have been held to be unconstitutional and many regulations of the Treasury have been overruled.

In a very old case the court said:

DECISION. . . . . The construction of the law is open to both parties, and each is presumed to know it. Any instructions from the Treasury Department could not change the law or affect the rights of the plaintiff. He was not bound to take or adopt that construction. He was at liberty to judge for himself, and act accordingly. . . . .[16]

The following statements, made in two more recent cases, are of interest in a consideration of the regulations of the Treasury:

DECISIONS. The question has been decided both ways in the Internal Revenue Department [Montgomery's *Income Tax Procedure* (Ed. 1918) pp. 231, 232]; and hence the effect usually given to an

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[15] Under this title Mr. Fred T. Field, formerly member of the Advisory Tax Board, presented a paper published in the *Columbia University Lectures—The Federal Income Tax* (Columbia University Press, 1921, pages 91-113) in which he makes the following statements: "Rulings are of two principal classes—administrative rulings which deal with procedure, and interpretative rulings which purport to state the meaning of the statute and to affect substantive rights. Administrative rulings are made under authority of a delegated quasi-legislative power, and if within the scope of the delegation, have the effect of law as quasi-statutes. They are presumed to be valid. Interpretative rulings have no effect as law since they are not within the delegation of the quasi-legislative power and since no power of conclusive quasi-judicial construction is given to the Treasury Department. Interpretative rulings are, however, under some conditions aids to the construction of the statute and have certain important practical effects."

[16] *Elliott v. Swartwout,* 35 U. S. 137, 10 Pet. 137, 12 Curtis 46, 9 L. Ed. 373.

established practice of an executive department charged with the execution of a statute has no present relevancy. (*United States v. Coulby*, 258 Fed. 27; 169 C. C. A. 165.)

A practical construction by public officers whose duty it is to enforce a statute is conceded to be entitled to great influence, provided the statute presents an ambiguity which is real, and not captious. . . .

Where a statute that has been construed by the courts has been re-enacted in the same or substantially the same terms, the legislature is presumed to have been familiar with its construction, and to have adopted it as a part of the law, unless a different intention is indicated; and the same principle is applied to statutes and parts of statutes which have been re-enacted after they have been construed by the legislative or executive departments of the government. (*Edwards v. Wabash Railway Co.*, 264 Fed. 610.)

Regarding the taxpayer's right to question rulings and assessments, the following authoritative quotation is pertinent:

And it follows that it will be a legitimate mode of construing the present income tax law, in cases where its language in relation to a particular point or subject is obscure, confusing, or unintelligible, to compare it with the corresponding provisions on the same point in the earlier acts, which may be more clear and precise, and to presume that Congress intended its words to be understood in the same sense as before, unless there is such a distinct change of language as to compel the inference that a change in legislation was certainly intended.[17]

Also the following quotations from decisions of the United States Supreme Court and other federal courts are of interest.

Decisions. In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen. *United States v. Wigglesworth*, 2 Story 369, Fed. Cas. No. 16,690; *American Net and Twine Co. v. Worthington*, 141 U. S. 468, 474, 35 L. Ed. 821, 824, 12 Sup. Ct. Rep. 55; *Benziger v. United States*, 192 U. S. 38, 55, 48 L. Ed. 331, 338, 24 Sup. Ct. Rep. 189.[18]

Keeping in mind the well-settled rule that the citizen is exempt from taxation unless the same is imposed by clear and unequivocal

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[17] Black, *Income and Other Federal Taxes*, 4th edition, page 36.
[18] *Goul v. Gould*, 245 U. S. 151, 38 Sup. Ct. 53, 62 L. Ed. 211.

language, and that where the construction of a tax law is doubtful, the doubt is to be resolved in favor of those upon whom the tax is sought to be laid.[19] . . . .

Taxpayers should inform themselves as to the attitude of the courts on doubtful points which arise in the course of the administration of the law as indicated by the foregoing quotations and by the following clear-cut statement in a recent case.

Decision. Where there is an ambiguity in the language of a statute imposing a tax, and that ambiguity raises a doubt as to the legislative intent, the persons upon whom it is sought to impose the burden are to be given the benefit of the doubt.[20]

In an earlier case this is found:

Decision. At the outset it may be remarked that a statute providing for the imposition of taxes is to be strictly construed, and all reasonable doubts in respect thereto resolved against the government and in favor of the citizen.[21]

The question of the authority of Treasury regulations is most aptly discussed in Black's *Income Taxes* (4th edition), page 9.

But of course it is not within the lawful power of these officers to go a step beyond the limits of the act of Congress under which their authority is exercised. They could neither bring within the purview of the law or of their regulations anything not definitely within the words of the act, nor except from its operation anything not clearly meant to be excluded, nor add to the burden of the taxpayer anything which Congress did not intend to impose upon him. But within the limits of their rightful authority, regulations prescribed by the Commissioner of Internal Revenue, pursuant to statutory authority, with the approval of the Secretary of the Treasury where necessary, in respect to the assessment and collection of internal revenue taxes, or for the government of the officers of the revenue department, have all the force and effect of law, and are as binding as if incorporated in the statute law of the United States; and the acts of the Commissioner are presumed to be the acts of the Secretary. But the construction given to an act of Congress impos-

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[19] *Spreckels Sugar Refining Co. v. McClain,* 113 Fed. 244, 51 C. C. A. 201; quoted with approval in 192 U. S. 397, 24 Sup. Ct. 376, 48 L. Ed. 496.

[20] *Edwards v. Wabash Railway Co.,* 264 Fed. 610, 619.

[21] *Mutual Benefit Life Ins. Co. v. Herold,* 198 Fed. 199; affirmed 201 Fed. 918, 120 C. C. A. 256; certiorari denied 231 U. S. 755, 58 L. Ed. 468, 34 Sup. Ct. 323.

ing internal revenue taxes by the Commissioner of Internal Revenue, though officially published, is not a construction of so much dignity that a re-enactment of the statute subsequent to the construction is to be regarded as a legislative adoption of that construction, and especially when the construction would make a proviso to the act repugnant to the body of the act.

In *Thacher v. United States,*[22] the court said:

DECISION. The Commissioner of Internal Revenue cannot alone, or in connection with the Secretary of the Treasury, alter or amend the internal revenue law. All he can do is to carry into effect that which Congress has enacted. His regulations in aid of the execution of the law must be reasonable, and made with a view to the due assessment and collection of the revenue.

Retroactive regulations.—It should be borne in mind that Treasury interpretations are, after all, merely interpretations. Therefore, if the courts decide that the law means something different from what the Treasury has held it to mean, the rulings must be reversed and redress granted or additional levies made back to the date of the passage of the law.

The following section permits the Commissioner to apply new regulations without retroactive effect. Prior to 1921, the Commissioners assumed that changes in regulations automatically became retroactive to the effective dates of the laws to which the regulations were applicable.

LAW. Section 1314. **That in case a regulation or Treasury decision relating to the internal-revenue laws made by the Commissioner or the Secretary, or by the Commissioner with the approval of the Secretary, is reversed by a subsequent regulation or Treasury decision, and such reversal is not immediately occasioned or required by a decision of a court of competent jurisdiction, such subsequent regulation or Treasury decision may, in the discretion of the Commissioner, with the approval of the Secretary, be applied without retroactive effect.**

If the Treasury should issue regulations interpreting a section of the law and later should change the interpretation by subsequent regulations, the author is of the opinion that, notwithstanding the foregoing section, a taxpayer overpaying a tax under the first interpretation can force a retroactive

[22] 15 Blatch. 15, Fed. Cas. No. 13851; affirmed 103 U. S. 679, 26 L. Ed. 535.

application of the latest regulation. If the Commissioner objects, it would be necessary to institute suit.

It should be noted that the language of the foregoing section is not mandatory.

Policy of the Bureau with regard to requests for rulings and advice upon abstract propositions.—

Ruling. Requests are being received daily for rulings and advice upon abstract cases or prospective transactions involving questions of income tax and profits liability. These requests are so numerous and the insistence on prompt action so great that it seems advisable at this time definitely to outline the Bureau's policy which will govern the consideration of these requests.

The Revenue Acts of 1918 and 1921 depart widely at many points from prior law or practice, and have given rise to new questions of such importance, complexity, and number that the resources of the Bureau are no more than adequate to advise taxpayers promptly of their present liabilities arising out of past transactions. It is impossible to answer every question which the invention or ingenuity of the inquirer may devise without neglecting the fundamental duty of determining tax liability upon the basis of actual happenings. Under these circumstances, the administrative necessity is obvious of giving precedence over abstract or prospective cases to actual cases in which the taxpayer desires to know what are his immediate liabilities under the law.

It will be the policy of the Bureau not to answer any inquiry except under the following circumstances:

(*a*) The transaction must be completed and not merely proposed or planned.

(*b*) The complete facts relating to the transaction, together with abstracts from contracts, or other documents, necessary to present the complete facts, must be given.

(*c*) The names of all the real parties interested (not "dummies" used in the transaction) must be stated, regardless of who presents the question, whether attorney, accountant, tax service, or other representative. (C. B. I-1, page 400; Mim. 2880.)

Administrative efficiency—evasion.—There is no entirely trustworthy information concerning the completeness of the income tax assessment. Some attempts to prove evasion, such as those in which comparisons are made between the number of returns and the number of automobiles in the

various states,[23] are interesting but inconclusive. Obviously it is a tax which can be evaded, at least for a time, by those who are willing to perjure themselves, but in spite of this the author believes that upon the whole the law is well observed.

Out of millions of returns there are sure to be some which are fraudulent. The Treasury should be unremitting in its efforts to punish the offenders. All reputable accountants and lawyers should lend their aid. If it be found that taxpayers have been advised how they can evade the law, the advisors should be indicted and punished as conspirators.

There are, of course, thousands of cases in which there have been differences of opinion as to what is and what is not taxable and as to what is and what is not deductible. The Treasury reverses its own decisions so often that procedure which is allowable one day results in technical "evasion" the next. Moreover, from a rather extensive knowledge of the facts, the author has come to the conclusion that in more than half the cases where additional sums were collected by assessments based on examinations, the taxpayers made no mistakes whatever in their returns, the original assessments being changed by incompetent revenue agents. The additional taxes, which would be classified as evasions, are paid in many cases without protest, *solely* because of the expense and annoyance of bringing suit.

The great difficulties under which the Treasury labors in securing competent assistants are, of course, apparent. Improvement in the quality of the administration, however,

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[23] See *Annalist,* December 13, 1920.

A very careful study of income has recently been made by the staff of the National Bureau of Economic Research (*Income in the United States,* Harcourt, Brace and Company, 1921). According to their best estimates (page 136), there were in 1918 no less than 5,290,649 persons in receipt of incomes in excess of $2,000. In contrast, there were less than three million income tax returns filed in that year. However, it is not to be concluded that the evasion is as great as might be inferred by these bare figures. "Income" as used in this study was not "taxable net income." It is significant also that 3,065,024 of the 5,290,649 persons, who were in receipt of incomes over $2,000, fell within the group of $2,000 to $3,000. The evasions are probably very largely those of persons just within the income tax paying class.

should be made steadily as the law becomes more clearly understood and more fully adjudicated. There is imperative need for better administration if widespread evasion is to be avoided. The heavy rates, coupled with a growing distrust of the Treasury, may easily give rise to a lamentable situation.

Legal effect of changes in form of organization which are made to reduce taxation.—The owners of the stock of a corporation dissolved the corporation and formed themselves into a partnership or trust, apparently in order to avoid paying excess profits tax on a contemplated sale of assets. The Treasury held that the tax nevertheless might be assessed against the corporation on the ground that the transaction was an attempt to evade a tax.

Ruling. A change of form from that of a corporation or association to that of a trust or partnership accompanied by a transfer of capital assets to trustees for the benefit of shareholders followed by a sale of such assets at a price in excess of the cost thereof to the corporation or association, and the distribution of proceeds to the beneficiaries (shareholders), such change being made for the main purpose of avoiding the tax which would accrue to the corporation had the sale been made by it, should be disregarded as a mere sham to avoid assessment of tax against the corporation or association upon the profit derived from such sale, and the corporation or association should be required to return as income any profit derived as though the sale had been made by it directly. (C. B. 2, page 203; Digest S. 1385.)

The taxpayer against whom the foregoing case was decided, appealed to the courts and the opinion of the Solicitor was reversed.[24]

Decision.[25] It is insisted in the opinion of the solicitor for the Bureau of Internal Revenue that this change is a sham and a subterfuge and is ineffective. This same opinion admits the right of an individual or corporation to regulate or change its business with a view of reducing or avoiding taxation in the future, but in contradiction with this admission holds that the parties involved in this transaction could not do so. Supporting this view there are several

[24] The position taken in the court decision above quoted is identical with that expressed by the author in his *Income Tax Procedure,* 1921, page 444.

[25] *Weeks v. Sibley,* 269 Fed. 155.

cited cases, most of them by state courts. The case of *Pollard v. Bank,* 47 Kans. 406, 28 Pac. 202, cited by the solicitor, is directly opposed to his contention. . . . .

Bearing in mind the rule of construction which the Supreme Court announced in the case of *Gould v. Gould,* 245 U. S. 151, 38 Sup. Ct. 53, 62 L. Ed. 211, and numerous other cases, to the effect that the provisions of the taxing statutes are not to be extended by implication beyond the clear import of the language used, and that they are to be construed most strongly against the government and in favor of the taxpayer, it is the opinion of this court that the right to change the status of an organization, or to dissolve an organization in any legal manner, is not made ineffectual because the motive impelling the change is to reduce or avoid taxation in the future. The right so to do is an incidental right, inseparably connected with an individual's right to own and control his property. It is practically identical with the sale by a citizen of tax-burdened securities and the investment of the proceeds thereof in tax-exempt ones, for the purpose of reducing or avoiding taxation.

It is not unnatural that any thoughtful business man take such steps. It is altogether different from tax dodging, the hiding of taxable property, or the doing of some unlawful or illegal thing in order to avoid taxation. . . . .

CHAPTER XI

DETERMINATION, ASSESSMENT AND PAYMENT

In this chapter will be discussed, (1) the determination of taxes by the Commissioner by way of audit of all returns before assessment, including taxpayers' original returns, amended returns and reports made by revenue agents recommending additional assessments; (2) the assessment of taxes admitted to be due, or found to be due after audit, hearing and appeal; and (3) the payment by the taxpayer of such assessments. Remedial measures available to taxpayers by way of claims in abatement or for credit after assessments have been made, and the various methods of securing refund of taxes erroneously or unlawfully assessed and collected, are dealt with in the following chapter.

Determination and Assessment

The function of determining and assessing the tax is delegated to the Commissioner.—

LAW. Section 1311. [Section 3176, Rev. Stat.] . . . . **The Commissioner of Internal Revenue shall determine and assess all taxes, other than stamp taxes, as to which returns or lists are so made under the provisions of this section. . . .**

The assessment of the income tax as a step in the administrative process of collection is not so formal nor so clearly defined as in most other types of taxes. This is especially true in the case of the tax assessed under original returns as contrasted with any additional taxes imposed after audit and examination. When the taxpayer fills out a return and accompanies it with his cheque, the precise point at which the Treasury "assesses" the tax is not apparent. Some authorities[1]

[1] Professor Carl C. Plehn, for example. See Bulletin of the National Tax Association, Vol. V, page 213.

believe there should be a formal assessment roll for the income tax.

Examination and audit—general.—

LAW. Section 250. . . . . (b) As soon as practicable after the return is filed, the Commissioner shall examine it. If it then appears that the correct amount of the tax is greater or less than that shown in the return, the instalments shall be recomputed: . . . .

REGULATION. When the returns are received at the collectors' offices they are examined and listed before being forwarded to the Commissioner. As soon as practicable after the returns are received in the office of the Commissioner they are carefully audited in connection with any reports of examination that may have been made by agents of the Department. If error in the amount of tax as stated in the return is detected the tax is recomputed and if the amount is less than that shown in the return the excess will be credited or refunded. . . . . If the amount is greater than that shown in the return the deficiency will be handled as provided in section 250 (d) of the statute and article 1006. . . . . (Art. 1012.)

The returns, or at least the larger ones, are audited exhaustively "as soon as practicable," but this is usually long after the payment of the tax.

Section 250 (b) of the 1918 and 1921 laws and the usual procedure which governs the examination of returns by revenue agents from the Commissioner's office in Washington, are supplemented by the provision of the law which gives to local collectors the right to question the accuracy of returns.

LAW. Section 228. That if the collector or deputy collector has reason to believe that the amount of any income returned is understated, he shall give due notice to the taxpayer making the return to show cause why the amount of the return should not be increased, and upon proof of the amount understated, may increase the same accordingly.[2] Such taxpayer may furnish sworn testimony to prove any relevant facts and if dissatisfied with the decision of the collector may appeal to the Commissioner for his decision, under such rules of procedure as may be prescribed by the Commissioner with the approval of the Secretary.

REGULATION. If a collector has reason to believe that the amount of any income is understated in a return, he may on his own initiative

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[2] See page 87.

take up the matter with the taxpayer and upon becoming satisfied that the amount was understated may increase it accordingly, subject to the right of the taxpayer to appeal to the Commissioner. The Commissioner, however, without the intervention of the collector may exercise original jurisdiction in cases of understatements or other errors in returns, in which event sections 250 and 1300 of the statute and section 3176 of the Revised Statutes, as amended by section 1311 of the statute, are applicable instead of section 228. . . . . (Art. 451.)

It is confusing to the average taxpayer to have his returns questioned from two different sources. In view of the right of appeal to the Commissioner in any event, if the collector gives notice of intention to increase an assessment, taxpayers should appeal at once to the Commissioner.

Collectors may summon any person residing or found within the state or territory in which their districts lie, and even in other districts, and make examinations authorized by the law. If a return is not filed, the collectors are required to make returns from their own knowledge and from such information as they can obtain through testimony or otherwise.

LAW. Section 1311. [Section 3172, Rev. Stat.]. **Every collector shall, from time to time, cause his deputies to proceed through every part of his district and inquire after and concerning all persons therein who are liable to pay any internal-revenue tax, and all persons owning or having the care and management of any objects liable to pay any tax, and to make a list of such persons and enumerate said objects.**

LAW. Section 1311. [Section 3165, Rev. Stat.] **Every collector, deputy collector, internal-revenue agent, and internal-revenue officer assigned to duty under an internal-revenue agent, is authorized to administer oaths and to take evidence touching any part of the administration of the internal-revenue laws with which he is charged, or where such oaths and evidence are authorized by law or regulation authorized by law to be taken.**

Examination of books and persons.—Treasury officers have full power to examine books and records and to require attendance of the necessary persons at examinations into the accuracy of income tax returns. The auditing and examinations, whether done in the office or in the field, are performed by internal revenue agents, who are under the direction of

the Commissioner at Washington and not of the local collectors.

Law. Section 1308. That the Commissioner, for the purpose of ascertaining the correctness of any return or for the purpose of making a return where none has been made, is hereby authorized, by any revenue agent or inspector designated by him for that purpose, to examine any books, papers, records, or memoranda bearing upon the matters required to be included in the return, and may require the attendance of the person rendering the return or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matter required by law to be included in such return, with power to administer oaths to such person or persons.

Law. Section 1310. (a) That if any person is summoned under this Act to appear, to testify, or to produce books, papers, or other data, the district court of the United States for the district in which such person resides shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

(b) The district courts of the United States at the instance of the United States are hereby invested with such jurisdiction to make and issue, both in actions at law and suits in equity, writs and orders of injunction, and of ne exeat republica, orders appointing receivers, and such other orders and process, and to render such judgments and decrees, granting in proper cases both legal and equitable relief together, as may be necessary or appropriate for the enforcement of the provisions of this Act. The remedies hereby provided are in addition to and not exclusive of any and all other remedies of the United States in such courts or otherwise to enforce such provisions. . . . .

Ruling. Under section 1305 [Section 1308 of the 1921 law] of the Revenue Act of 1918, it is held that the Commissioner of Internal Revenue is authorized, by any revenue agent or inspector designated by him for that purpose, to examine any of the books, papers, records or memoranda of a bank, bearing upon any matter required to be included in a tax return of one of its depositors or customers. The bank, however, is entitled to satisfy itself in a reasonable manner of the official character and authority of any person making request to examine books or accounts of the bank as an official of the Internal Revenue Bureau. (C. B. 3, page 371; O. D. 609.)

It should be noted that the liability to examination extends to persons, other than the taxpayer, who have knowledge of his income.[3]

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[3] *In re Chadwick*, 5 Fed. Cas. 401, Fed. Cas. No. 2570, held that a corporation was not compelled to produce its books upon an inquiry into the income of its stockholders.

Relations with revenue agents.—The author has frequently been asked by taxpayers: "What shall we do when a revenue agent calls?" Perhaps taxpayers will have a better understanding of their own obligations if acquainted with the duties of revenue agents, as set forth in the regulations. These are, in part, as follows:

Ruling. The duties of officers of this class are to ascertain and report the names of persons who in their opinion are liable to the income tax and who have failed to make return as required by law; to inquire into income tax returns where there is any suspicion that the return made is erroneous; to examine the books and accounts of persons who have made returns, for the purpose of ascertaining and reporting as to whether the law has been complied with. . . . .

In the discharge of their official duties officers of this class, as well as all officers of the Internal Revenue Bureau, in making inquiries and investigations are expected to exercise sound discretion, treat all persons with due courtesy, and, while acting firmly and courageously, to avoid all contention or controversy that would give just ground for complaint. (T. D. 1932, January 13, 1914.)

Revenue agents usually call upon individual taxpayers without notice. In the case of business concerns appointments convenient to both are often made by telephone. Although the right of revenue agents to examine the books and accounts of all taxpayers is unquestioned, the author does not know of an instance when an immediate examination has been insisted upon to the inconvenience of the taxpayer.

Taxpayers should furnish the revenue agent with all information called for and expedite the examination by placing at his disposal the original data supporting the returns. In case of doubt, too much rather than too little information should be tendered.

Field agents, as a general rule, discuss their proposed reports very freely with taxpayers. When the examination has been made by an agent under the immediate supervision of the revenue agent in charge of a particular district, the taxpayer is sent a copy of the report after it has been reviewed by the agent in charge. If an examination is made by an agent directly from Washington, a copy of the report is not fur-

nished the taxpayer. The assessment letter[4] is the first official notice to the taxpayer of the results of the examination.

Unnecessary examinations.—

Law. Section 1309. That no taxpayer shall be subjected to unnecessary examinations or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Commissioner, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

This section carries no assurance of a decrease in the number of examinations. In the discretion of the Commissioner as many may be made in the future as have been made in the past.

Procedure when audit discloses additional taxes due.—

Law. Section 250. . . . . (d) . . . . If upon examination of a return made under the Revenue Act of 1916, the Revenue Act of 1917, the Revenue Act of 1918, or this Act, a tax or a deficiency in tax is discovered, the taxpayer shall be notified thereof and given a period of not less than thirty days after such notice is sent by registered mail in which to file an appeal and show cause or reason why the tax or deficiency should not be paid. Opportunity for hearing shall be granted and a final decision thereon shall be made as quickly as practicable. Any tax or deficiency in tax then determined to be due shall be assessed and paid, together with the penalty and interest, if any, applicable thereto, within ten days after notice and demand by the collector as hereinafter provided, and in such cases no claim in abatement of the amount so assessed shall be entertained: *Provided,* That in cases where the Commissioner believes that the collection of the amount due will be jeopardized by such delay he may make the assessment without giving such notice or awaiting the conclusion of such hearing. . . . .

Regulation. Section 250 (d) of the Revenue Act of 1921 provides that if upon examination of a return made under the Revenue Act of 1916, 1917, 1918, or 1921, an income or excess profits tax or a deficiency therein (which deficiency is defined in Section 250 (b) as meaning the difference, to the extent not covered by any credit due to the taxpayer under Section 252, between the amount of the tax already paid and that which should have been paid) is discovered the taxpayer shall be notified thereof and shall have the right of an

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[4] See Art. 1006.

appeal and a hearing before an assessment is made. As soon as practicable, therefore, after a return is filed, whether by the taxpayer or as provided in section 3176 Revised Statutes, as amended, it is examined and if a tax or a deficiency in tax is discovered, the taxpayer shall be notified thereof by registered mail and a period of not less than 30 days given the taxpayer in which to file an appeal to the Commissioner and show cause or reason why such tax or deficiency should not be paid. Full 30 days from the mailing (not the receipt) of such notice to file an appeal shall be given the taxpayer. The appeal must be filed in the office of the Commissioner in Washington within 31 days from the mailing of the notice, but if it is mailed in time to be received by the Commissioner within such period in the ordinary course of the mails it will be considered as having been filed within such period. No particular form of appeal is required, but the appeal must set forth specifically the exceptions upon which it is taken. The appeal shall be under oath and must contain a statement that it is not taken for the purpose of delay. The facts and grounds upon which the taxpayer relies in connection with his appeal must be fully stated.

Upon the receipt of the appeal and before it is made the subject of a hearing by the agency designated by the Commissioner to hear such appeal, the appeal will be referred to the income tax unit in Washington, or, to the division thereof where such proposed assessment is being considered. The taxpayer may request a conference before the income tax unit to be held within a period prior to the expiration of five days after the time for the filing of an appeal. Five days prior to the expiration of the time allowed for a conference the taxpayer shall submit all data and briefs upon which he relies in connection with his appeal. If the income tax unit and the taxpayer are unable to reach an agreement respecting the amount of the proposed assessment, the appeal shall be transmitted to such agency as the Commissioner may designate for consideration and hearing. Opportunity for a hearing before the appeal agency shall be granted if requested within a reasonable time in accordance with the practice and procedure of such agency. The taxpayer in his appeal may rely upon data previously submitted, or he may obtain a reasonable extension of time, if cause therefor is shown, in which to file additional data, evidence or argument.

Such request shall be under oath and must state specifically the reasons for additional time.

In the case of a return which is examined in the collector's office where a tax or deficiency therein is discovered, the taxpayer will be notified thereof by registered mail and the same period given the taxpayer in which to file an appeal to the Commissioner and show cause or reason why such tax or deficiency should not be paid. Such appeal shall be filed in the manner prescribed above. The appeal will be referred to the collector's office where such proposed

assessment is being considered. The procedure in connection with such appeal shall be the same as hereinbefore provided in the case of appeals from the decision of the income tax unit.

No assessment under section 250 (d) shall be made without notification to the taxpayer of his right to appeal and show cause, except that in any case where the Commissioner believes that the collection of the amount due will be jeopardized by delay, he may make the assessment without giving such notice or awaiting the conclusion of a hearing.

Where a taxpayer has been given an opportunity to appeal and has not done so, as above set forth, and an assessment has been made, or where a taxpayer has appealed and an assessment in accordance with the final decision on such appeal has been made, no claim in abatement of the assessment shall be entertained.

Where an assessment has been made without giving the taxpayer an opportunity to appeal or without awaiting a decision on an appeal that has been perfected, a bona fide claim in abatement of the assessment, filed within ten days after notice and demand by the collector, may be entertained. (Art. 1006, as amended by T. D. 3409, November 13, 1922.)

It is clear from the law and regulations that if the examination of the original return or of the accounts of the taxpayer indicates that an additional amount is due, an assessment will be made, but only after the taxpayer has had ample opportunity to persuade the Treasury that the contemplated assessment is incorrect.

Prior to the modification of article 1006 by T. D. 3409 on November 13, 1922, it was the practice of the Treasury to send *two* letters to the taxpayer—an assessment letter (not by registered mail) giving taxpayers an opportunity to present exceptions to the Income Tax Unit within a period of 20 or 30 days, and a registered letter giving the decision of the Income Tax Unit from which taxpayers could appeal to the Commissioner within a period of 30 days as provided in section 250 (d) of the 1921 law.

This twofold appeal has now been abolished by T. D. 3409. The author believes that this change has resulted from the necessity for making assessments under the 1917 law before March 1, 1923, and that there is a possibility of reversion to the old procedure when the period of emergency has passed.

The procedure under T. D. 3409 makes it essential for the taxpayer to file an appeal with the Treasury within 30 days from the date of the registered letter; otherwise an assessment will be made and the tax so assessed will have to be paid, no claim for abatement being permissible.

Statement for submission with report of inspector—preliminary hearing.—As a first step, which is not specifically provided for in the regulations, it is sometimes helpful, when an examination has developed points of dispute between the taxpayer and the revenue agent, to prepare a statement of all relevant facts, furnish one copy of it to the revenue agent with a request that it be forwarded to the Treasury and send another copy, with affidavit attached, to the personal or corporation audit department (as the case may be) of the Income Tax Unit at Washington. This does not constitute an amended return, but merely insures a full presentation of the taxpayer's side of the case for consideration by the audit section, which will also have before it the report of the revenue agent. If the taxpayer does not feel that his statement, unsupported by oral evidence, is sufficient, he may in the copy forwarded to Washington request a hearing and an opportunity to submit additional evidence if it should appear to the audit section that an adverse report is likely to be made. Usually, if such a request is filed, the taxpayer will be granted a hearing in person or by attorney before any additional tax is assessed against him. After the hearing a decision will be made by the audit section from which the usual appeal can be taken.

Notice of proposed assessment.—If the Treasury's audit (which may or may not include the consideration of the taxpayer's statement and the preliminary hearing outlined in the preceding paragraph) makes it appear that an additional assessment is justified, "the taxpayer shall be notified thereof and given a period of not less than thirty days after such notice is sent by registered mail in which to file an appeal

and show cause or reason why the tax or deficiency should not be paid."[5]

Generally, an assessment letter is accompanied by a form asking the taxpayer either to consent to the additional tax or to protest against it. If the taxpayer consents to the assessment, then he waives his rights to a hearing and appeal under section 250 (d). These forms should not be signed without proper advice. Taxpayers should also be sure that they understand what action has been taken on claims for refund, credit, or abatement which may be on file. Sometimes an assessment letter may show an overpayment, but when consideration is also given to a claim for abatement previously filed which has been rejected, the "overpayment" becomes merely a partial offset to a larger amount of additional tax.

Protest and appeal.—All communications from the Treasury regarding additional assessments should receive prompt attention.

In many cases, especially where the amount involved is very large, it will not be possible to file a complete brief taking up in detail the proposed assessment. In such cases, it should be sufficient, as is contemplated by article 1006, to file the formal appeal, setting forth the items which will be contested and the general reasons why the tax should not be paid. These reasons, however, should not be too general, but should be specific enough to enable the Treasury to decide whether or not the contentions are meritorious.

Taxpayers should make all appeals in good faith and as soon as practicable. This will encourage a fair administration of the law. Taxpayers should request reasonable extensions of time in which to prepare properly the details of their cases. In all complicated cases an oral hearing should be requested, since the questions involved are of the same nature as in litigated cases and no one would think of taking a case

[5] Section 250 (d).

into the courts and of waiving the right of argument before a judge or a jury.

FORM OF APPEAL.—An appeal must be in affidavit form and contain a statement that it is not taken for the purpose of delay. These are the only requirements set forth in the regulations. The following form may be used in most cases:

(*Specimen Appeal*)

TREASURY DEPARTMENT

BUREAU OF INTERNAL REVENUE

IN THE MATTER OF JOHN SMITH & CO., INC.	APPEAL

TO THE COMMISSIONER OF INTERNAL REVENUE:

The above named taxpayer is in receipt of a registered letter, dated.............................., advising it that it has been decided that a proposed additional income tax of $........, for the years ...., will be assessed after the expiration of thirty days unless an appeal is filed within that time.

Accordingly an appeal is hereby taken from such decision, which it is understood was rendered by the............................ (Division, Subdivision or Section, as the case may be) of the Income Tax Unit.

STATEMENT OF FACTS

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....

EXCEPTION NO. I.

THE TAXPAYER TAKES EXCEPTION TO THE INCOME TAX UNIT'S REDUCTION OF THE DEPRECIATION RATE FOR MACHINERY AND EQUIPMENT FROM 10 PER CENT TO 7½ PER CENT.

The above taxpayer is engaged in manufacturing cotton goods. It has for the past six years, the period of its existence, depreciated machinery and equipment at the rate of 10 per cent per annum.

Proof has been submitted to show that, under the circumstances, 10 per cent per annum is a reasonable rate of depreciation.

EXCEPTION No. II.

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EXCEPTION No. III.

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CONCLUSION

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The taxpayer requests an oral hearing, and reserves the right to submit additional evidence and a supplementary brief.

This appeal is not taken for the purpose of delay.

Respectfully,

Dated.................... JOHN SMITH & Co., INC.

By..............................

(Name of official)

STATE OF.................... }
COUNTY OF................. } ss.

.................................., of full age, being duly sworn according to law, on his oath says that he is the............... .... of the above named company, that the facts set forth in the foregoing appeal to the Commissioner of Internal Revenue are true to the best of deponent's knowledge and belief.

....

(Name of official)

Subscribed and sworn to before me
this........day of..........192..

....

Notary Public

Procedure upon assessment.—After final decisions are made, or if appeals are not made within the specified time, the proposed assessments are included in the next list sent to the collector by the Commissioner.[6] Upon receipt of the lists, the collector issues notice and demand for payment as soon as possible. The tax must be paid within ten days after notice and demand. The collector cannot accept a claim in abatement.[7] If the taxpayer still wishes to contest the assessment, a claim for refund may, however, be filed immediately after payment is made—a procedure which is necessary in order to file suit.[8] Under all circumstances payments should be made under protest.[9]

Time limits on summary assessments.—

LAW. Section 250. . . . . (d) The amount of income, excess-profits, or war-profits taxes due under any return made under this Act for the taxable year 1921 or succeeding taxable years shall be determined and assessed by the Commissioner within four years after the return was filed, and the amount of any such taxes due under any return made under this Act for prior taxable years or under prior income, excess-profits, or war-profits tax Acts, or under section 38 of the Act entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," approved August 5, 1909, shall be determined and assessed within five years after the return was filed, unless both the Commissioner and the taxpayer consent in writing to a later determination, assessment, and collection of the tax; and no suit or proceeding for the collection of any such taxes due under this Act or under prior income, excess-profits, or war-profits tax Acts, or of any taxes due under section 38 of such Act of August 5, 1909, shall be begun, after the expiration of five years after the date when such return was filed, but this shall not affect suits or proceedings begun at the time of the passage of this Act: *Provided,* That in the case of income received during the lifetime of a decedent, all taxes due thereon shall be determined and assessed by the Commissioner within one year after written request therefor by the executor, administrator, or other fiduciary representing the estate of such decedent: *Provided further,* That in the case of a false or fraudulent return

[6] Lists are usually sent to the collectors about the 10th of each month. Sometimes, however, a special list is sent.

[7] See Art. 1006, page 213.

[8] See Chapter XII.

[9] See page 253.

with intent to evade tax, or of a failure to file a required return, the amount of tax due may be determined, assessed, and collected, and a suit or proceeding for the collection of such amount may be begun, at any time after it becomes due: *Provided further,* That in cases coming within the scope of paragraph (9) of subdivision (a) of section 214, or of paragraph (8) of subdivision (a) of section 234, or in cases of final settlement of losses and other deductions tentatively allowed by the Commissioner pending a determination of the exact amount deductible, the amount of tax or deficiency in tax due may be determined, assessed, and collected at any time; but prior to the assessment thereof the taxpayer shall be notified and given a period of not less than thirty days in which to file an appeal and be heard as hereinafter provided in this subdivision. . . . ..

It should be noted that the tax must be both determined and assessed within the limitation period.

LIMITATION PERIOD FIVE YEARS UNDER 1918 AND PRIOR LAWS.—The limitation period of the 1918 law is not disturbed, but in the case of all acts prior to the 1918 law, the period was increased to five years by the 1921 law. Before this change, the government, notwithstanding that assessment could not be made, could bring suit at any time under laws prior to the 1918 act. The 1921 law now provides that neither assessment nor suit under 1918 and prior laws shall be legal after the five-year limitation period has expired.[13]

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[13] **[Former Procedure]** Prior to the enactment of the 1921 law, the government under the 1917 law [section 14 (a)] was unable to make assessment and to enforce payment of an additional tax by the usual (summary statutory) proceedings after three years had elapsed since date at which the return was due. It could, however, when it discovered, or alleged that it had discovered, additional tax to be due, bring suit at any time against the taxpayer for the amount alleged to be due. This was a distinct advantage to a taxpayer, because it shifted the burden of proof from himself to the government and made the case altogether different from one in which the government was able to send in a bill, compel payment and put upon an innocent taxpayer the cost of initiating a suit.

The Bureau claims (C. B. 3, page 302; Sol. Op. 79) that if a "discovery" shall have been made within three years from the time the return was due assessment may be made at any time thereafter. Such, however, could hardly have been the intention of the law. To the mind of the author the punctuation conveys the very clear meaning that assessments must be made immediately after discovery and the additional tax must be paid upon demand and that the discovery and the assessment must be made within three years from the time when the return was due. Any other construction is a strained one. As the section covers the imposition of penalties it should be construed in favor of the taxpayer. The United States courts have not

Definition of word "assessment".—As section 250 (d) provides that additional taxes "shall be determined and assessed within five years after the return was filed," it is important to know what the words "determined and assessed" mean.

The Treasury holds that an assessment is made when the Commissioner signs the list to be sent to collectors. (It is assumed that the list is dated the precise day of the signature, otherwise the rule would be an absurd one.) This means that a list may be signed on the last day of the 5-year period and the taxpayers notified later. The Commissioner contends that if the tax is not paid when demanded by the collector it may be collected by distraint. Thus the assessment is a secret pro-

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specifically passed upon this question. In a suit brought within three years from the time when a return was due (*Eliot National Bank v. Gill,* 218 Fed. 600, 134 C. C. A. 358) the court said that the tax could be assessed after three years if the fact that it was due was discovered within the three years. But the point in question was not before the court, so that the statement is *dictum,* and need not be considered a precedent.

It is well settled that where a tax of a fixed percentage is imposed by statute, or is so definitely described in the statute that its amount can be readily ascertained or determined, no assessment need be made in order to recover the tax. In the case of *United States v. Grand Rapids, etc., Railway Company,* 239 Fed. 153, the United States District Court held that the limitation in the statute is a limitation upon the right of collectors to make assessment and to enforce payment by the customary summary proceedings, but does not prevent suit for taxes, which will lie without an assessment. (Judgment affirmed, 256 Fed. 989 [mem.].)

The Commissioner has made a large number of assessments under this "discovery" theory. Many taxpayers have refused to pay and have filed claims for abatements. In many cases, there is some doubt about "discovery" having been made within the three years. If the courts upset the Treasury's construction, or if upon appeal within the department it is found that discovery was not made within the three-year period, it is doubtful if assessment can now be made, as under the 1921 law assessment must be made within five years. The first assessment being declared illegal places the case in the same position as though no assessment had been made.

The Treasury has also held the following with reference to the three-year limitation period:

Ruling. 1. The extension of time granted by the Commissioner to taxpayers for filing their income returns operates to shift the due date for filing their returns to the expiration of the period of extension; the three-year limitation begins to run from the due date as thus shifted.

2. Where an excess amount of tax is assessed, the Commissioner is authorized by section 3220, R. S., as amended by the Revenue Act of 1918 to abate the excess amount.

3. Where the tax assessed is less than the amount due an assessment of the additional amount due can be made, where discovery was made within the three-year limitation period. . . . (C. B. 4, page 325; Sol. Op. 92.)

ceeding with no notice to taxpayers. The Commissioner takes his own time and thus opens the way to actual assessment long after the statutory time has elapsed. All he needs is a rubber stamp.

Practically all court decisions dealing with the question of "assessment" grow out of general property taxes. Generally speaking, the word "assessment" under the property taxes carries two elements, viz., (1) determination or computation of the tax, and (2) recording in a public record which is open to the public.[14]

It is difficult to believe that Congress intended the word "assessed" to mean what the Commissioner says it does. Congress evidently attached some significance to the phrase "determined and assessed." A fair interpretation would be that the word "determined" means that the Commissioner must compute the tax and send a list to the collector within the statutory period, and the word "assessed" should be interpreted to mean the list must be received and the taxpayer actually assessed (which can be done only by notice) within the statutory period. At the time the 1921 law was passed the ordinary meaning of the word "assessment" was that a collector had demanded an additional tax. It is doubtful if Congress intended that an assessment could be made without the taxpayer receiving notice.

Section 250 (d) states specifically that no suit shall begin "after the expiration of five years after the date when the return was filed." If it is reasonable to say that assessment can be made by the Commissioner signing a list in his office, it is just as reasonable to say that a suit has been begun by a district attorney who draws certain formal papers and signs them within the statutory period but does not file them and does not notify the taxpayer of the suit. No court would say that the signature on the complaint constituted the beginning of a suit within the statutory period.

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[14] 26 R. C. L. 340.

The use of the word "proceeding" in the 5-year limit for suits also shows that Congress meant that the taxpayer must receive notice within five years. The words "determined and assessed" certainly can not include the distraint warrant. The word "proceeding" was no doubt intended to cover distraint warrants. There would be no meaning in having an amount payable if it could not be collected either by distraint or suit. The Treasury does not agree with this interpretation of the word "proceeding."[15] A ruling has been issued (I-37-504; I. T. 1446) holding that the word "refers only to judicial proceedings for collection of such taxes and not to the summary proceedings by means of distraint." It is significant that no reasons are stated to support the conclusion, and, furthermore, when the distraint warrant is referred to in the ruling it is called "the summary proceeding," yet the use of a distraint warrant is claimed not to be a "proceeding."

It should also be remembered that when section 250 (d) was written, taxpayers demanded that Congress insert a provision in the law which would enable them to know definitely when tax questions for a particular year are closed. Under the Treasury's interpretation, it would be possible for the Commissioner to sign a list on the last day of the statutory period, and for various reasons, the taxpayer might not be notified for weeks or months. For instance the assessment list might be misplaced in either the Commissioner's or the collector's office, or it might be lost in the mail. In the meantime the taxpayer believes the matter is closed and acts accordingly. The Treasury's interpretation might thus defeat the purpose of the section.

There are numerous decisions of the United States courts holding that assessment is frequently unnecessary in tax cases

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[15] In *U. S. v. Grand Rapids & I. Ry. Co.* (239 Fed. 153, affirmed 256 Fed. 989) the court said: "The three-year clause of the fifth subdivision of section 38 of the 1909 Excise Law is . . . a limitation upon the right of the collecting officers to make assessment and to enforce payment by the summary statutory proceedings." And in the case of *U. S. v. Bristow,* 20 Fed. 378, the court stated that "notice is also necessary before the collector can distrain for taxes."

on the ground that to assess is to determine the person to be taxed, the value of the thing taxed and the amount of the tax.[16] The courts have also held that a tax may not be collected by distraint warrant unless the taxpayer has been duly notified according to law.[17]

In recent tax laws, however, Congress has gone much further than it did in the earlier laws. In view of the enormous amounts involved, determination is of the greatest importance. The word "determination" comprehends careful and impartial investigation. But taxpayers are supposed to be protected after the expiration of five years. The specific limitation in the 1921 law outweighs the rule running through the decisions that time is not an important element.

The cases are uniform in stating that the assessment list is conclusive evidence that an assessment has been made.[18] This can be true without hurting the foregoing argument; under the 1921 law there need only be added "provided the taxpayer is notified within the period."

Limitation period four years under 1921 law.—Any tax due under a return filed for the taxable year 1921, or any subsequent year, must be assessed within four years after the return was filed. If, however, any tax is due under any return made under the 1921 law for prior taxable years, the assessment must be made within five years after the return was filed.

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[16] *Dollar Savings Bank v. U. S.*, 19 Wall. 227, 22 L. Ed. 80; *U. S. v. Erie Railway Company*, 17 Otto 1, 27 L. Ed. 385; *King v. U. S.*, 99 U. S. 229; *U. S. v. Philadelphia, etc., R. R. Co.*, 123 U. S. 113; *Bell's Gap R. R. Co. v. Pennsylvania*, 134 U. S. 232. It has been held, under the Revenue Act of 1909, that assessment is not a condition precedent to collection by suit. *U. S. v. Grand Rapids & I. Ry. Co.*, 239 Fed. 153, affirmed 256 Fed. 989; *N. Y. Life Insurance Co. v. Anderson*, 257 Fed. 576; *U. S. v. Waddell Inv. Co.*, 275 Fed. 934. The 1921 law, however, differs from other tax laws in that suit must be instituted within a specified time.

[17] *Parker v. Rule*, 9 Cranch 64, 3 L. Ed. 658; *Early v. Homans*, 16 Howard 610, 14 L. Ed. 1079; *U. S. v. Allen*, 14 Fed. 263.

[18] *W stern Express Co. v. U. S.*, 141 Fed. 28, 72 C. C. A. 516; *U. S. v. Bristow*, 20 Fed. 378; *Delaware R. Co. v. Prettyman*, Fed. Cas. No. 3767; *U. S. v. Rindskopf*, 15 Otto 418, 26 L. Ed. 1131. See also dissenting opinion of Mr. Justice Bradley in *Dollar Savings Bank v. U. S.*, 19 Wall. 227, 22 L. Ed. 80.

The limitation period for taxes under the 1921 law is not the same for assessment and suit. Assessment must be made within four years and suit or proceedings must be instituted within five years after the return was filed.

Limitation period one year in case of estates.—Section 250 (d) provides, "that in case of income received during the lifetime of a decedent, all taxes due thereon shall be determined and assessed by the Commissioner within one year after written request therefor by the executor, administrator, or other fiduciary representing the estate of such decedent."

A request for determination must be made by the executor. Such an application should be rendered unnecessary by more expeditious handling of returns. This section does not apply to the income of the decedent's estate but only to that received by the decedent during his lifetime.

The one-year period does not apply to suits. The government has five years after the return was filed within which to institute suit.

No limitation period in case of false or fraudulent return.—Under the provisions of section 250 (d) quoted on page 218 when a taxpayer has filed a false or fraudulent return with intent to evade tax, or has failed to file a required return, an assessment may be made or suit instituted at any time.

Limitation period where amortization is claimed or deductions are tentatively allowed.—The last proviso of section 250 (d) is of especial importance to taxpayers who have filed amortization claims.

It would appear that in a case where amortization has been claimed or where the Commissioner has tentatively allowed a deduction, the Commissioner may reopen the case to make an assessment or bring suit at any time. The assessment or suit would have to be confined to amortization or to

the deduction tentatively allowed. The other limitation periods of section 250 (d) would apply to the other items of the return.

There is an apparent conflict between section 250 (d) and section 214 (a-9). Section 234 (a-8) has the same language as section 214 (a-9). One applies to individuals and the other to corporations.

LAW. Section 214. (a) . . . . (9) . . . . At any time before March 3, 1924, the Commissioner may, and at the request of the taxpayer shall, reexamine the returns, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the income, war-profits, and excess-profits taxes for the year or years affected shall be redetermined; and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252; . . . .

The rule of law is that a specific section controls a general section. It might be thought that each section is specific. A careful reading shows, however, that section 214 is specific with reference to the deduction for amortization, whereas section 250 is specific with reference to limitation.

Should the courts hold that section 214 governs section 250, the Commissioner would have to complete all re-examinations of amortization claims before March 3, 1924, but could make an assessment or bring suit thereon at any time thereafter.

LIMITATION PERIOD MAY BE EXTENDED BY AGREEMENT.—A provision included in section 250 (d) makes it possible to extend the time limit on assessments upon consent of the Commissioner and the taxpayer. This provision will no doubt be attacked in the courts if taxpayers should inadvertently sign waivers in ignorance of their legal rights. There is a question as to the validity of this section. There must be consideration to support such an agreement. If the agreements which are made under this section are legal, the author is of the opinion that the agreements must be entered

into in a formal manner. So-called waivers heretofore secured by revenue agents are not agreements within the meaning of the law. The law states that the period must be extended by "both the Commissioner and the taxpayer."

Waivers or agreements covering additional taxes for the years 1909 to 1915, inclusive, are illegal.—A taxpayer may have given a waiver to a revenue agent for the above years. The agent recommends that additional taxes be assessed for these years. The Income Tax Unit sustains the agent's findings and notifies the taxpayer by registered letter of the proposed additional assessment. The taxpayer files an appeal setting forth his exceptions and requests a hearing. The merits of the case are discussed with the Income Tax Unit but the Unit decides to abide by its original decision.

The case is then transferred to the Committee on Appeals and Review. After a formal hearing, the Committee decides to sustain the Income Tax Unit. The taxes for the years 1909 to 1915, inclusive, are assessed.

The taxpayer is of the opinion that both the Income Tax Unit and the Committee are in error. He, therefore, has the right to resort to the courts. If the taxes are paid, however, he is precluded (as will be seen presently) from filing a claim for refund. And as claim for refund must be filed before suit is filed, he cannot institute suit. The taxpayer, therefore, does not have an adequate remedy at law, and the collector could be restrained from collecting the taxes for these years by distraint.

Section 1316 of the 1921 law amended Section 3228 of the Revised Statutes to read as follows:

> All claims for the refunding . . . . of any internal revenue tax . . . . must be presented to the Commissioner of Internal Revenue within four years next after payment of such tax. . . .
>
> This section . . . . shall apply retroactively to claims for refund under the Revenue Act of 1916, the Revenue Act of 1917, and the Revenue Act of 1918.

It should be noted that no provision is made for claiming

refunds where additional taxes have been paid under the 1909 and 1913 laws.

The words in the second paragraph of section 1316, "except as modified by section 252," evidently refer to the provision in section 252 whereby refunds, due *prior* to 1916 arising from failure "to take adequate deductions in previous years" when disclosed by examinations for the excess profits tax years may be allowed even though the 4-year or 5-year period has expired.

It was contended by the Government in the *du Pont* case that the last paragraph of section 3228 was intended to apply retrospectively to claims already filed under certain prior acts, which claims are covered by the last proviso of section 252 which states:

> That nothing in this section shall be construed to bar from allowance claims for refund filed prior to the passage of the Revenue Act of 1918 under sub-division (a) of section 14 of the Revenue Act of 1916, or filed prior to the passage of this Act under section 252 of the Revenue Act of 1918.

The foregoing language is very specific and completely covers claims filed under certain prior acts. If the last paragraph of section 3228 had been intended to cover such claims, the language should have been just as specific. Furthermore, there is no reason why section 3228 should deal with claims which *had been filed.* Section 3228 relates only to claims which *are to be filed* when payment is made; it does not relate to allowance of claims. Section 252 deals specifically with the allowance of all claims, and covers in no uncertain language claims which were filed under certain prior acts. It can merely be inferred that the last paragraph of section 3228 applies to claims filed under prior acts. Why should a meaning by inference be read into section 3228 when the purpose is specifically provided for in section 252? The last paragraph of section 3228, therefore, applies only to claims *to be filed* and not to claims which *may have been filed* prior to the passage of the 1921 law.

Section 1318 of the 1921 law amended Section 3226 of the Revised Statutes to read as follows:

> No suit or proceeding shall be maintained in any court for the recovery of any internal-revenue tax . . . . until a claim for refund or credit has been duly filed with the Commissioner of Internal Revenue. . . . .

The foregoing sections deny the aforementioned taxpayer the right to be heard by the courts. He, therefore, has no adequate remedy at law and the collector should be restrained from collecting the taxes by distraint.

The foregoing is supported by the recent decision of the Federal District Court of Delaware in the case of *du Pont v. Graham.*[19]

In that case the collector on December 31, 1919, demanded that du Pont pay an additional tax of $1,576,015.86 for the year 1915. The Commissioner contended that assessment had been made within the three year period as defined by section E of the 1913 law. As demand for payment was made December 31, 1919, a claim for abatement was filed to await the decision in the *Phellis* case, which was decided by the United States Supreme Court November 21, 1921. Two days later the 1921 law was approved which changed the statutory period for assessments, refunds and suits. The court's decision is, in part, as follows:

> As the five years from the date when the return was due, namely, March, 1916, has long since expired, the plain meaning of the above section [Section 252] is that no credit or refund could now be lawfully allowed or made because no claim therefor was filed by the plaintiff within five years. It is evident that Congress intended by the provision of Section 250 (d) of the Act of 1921, to provide a definite five year limitation for the beginning of suits or proceedings for collection of taxes enumerated. If the revenue officers should unduly delay the assessment of taxes and the commencement of proceedings for collection, Congress has determined that five years after the due date of the return is a reasonable time to bring to an end the right to collect.

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[19] June 13, 1922; not yet reported.

. . . . I cannot conceive that Congress intended the taxpayer to be rigidly held to the inhibition of Section 3224 (this section provided that 'no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court') if the effect should be to nullify the inhibition against the officers of the revenue contained in the later statutes and thus subject the taxpayer to proceedings by distraint without leaving him an adequate remedy at law, after the limitation had run against the collector's right to begin such proceedings. It would be contrary to equity to hold that, where no remedy is available at law, equity will fail to afford relief.

Section 3228 of the Revised Statutes as amended by section 1316, did not apply to this case as it is only retroactive to the 1916, 1917 and 1918 laws. The Treasury accepts this interpretation in the following ruling:

Ruling. . . . . It will be observed that this amendment served to extend the time within which claims for refund may be filed to four years and this provision is made retroactive in so far as it relates to claims for refund filed under the Revenue Act of 1916, the Revenue Act of 1917, and the Revenue Act of 1918. At the time of the passage of the 1921 Act more than four years had elapsed since the date of the payment of both the original and the additional tax, and as these payments were for a tax under the 1913 Act, and as section 3228, Revised Statutes, is not made retroactive as to claims for refund under the 1913 Act, it follows that no relief is open to the taxpayer from this source. . . . . (C. B. I-1, page 311; I. T. 1269.)

The court granted the injunction and restrained the collector from proceeding under a distraint warrant.[20]

Taxpayers should not sign blanket extensions or waivers. The agreements should be carefully drawn and a limitation date specifically mentioned.[21]

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[20] The Government has appealed from this decision.

[21] In December, 1920, the Commissioner notified many taxpayers that there would not be sufficient time before March 1, 1921, to audit all 1917 returns and asked for waivers. When taxpayers had good reasons to infer that the Bureau would rush through an audit and assess additional taxes without proper investigation (as the letter of the Commissioner intimated would be done), perhaps it was the part of wisdom to relinquish one's legal right and yield to the "hold-up." Those who had no definite knowledge of proposed additional assessments should not have signed the waivers.

There is a serious question as to the validity of waivers executed after the expiration of the three-year limitation. The law does not authorize the Commissioner to extend this period. Furthermore, the consideration cited

No limitation period for examination of books.—There is no time limit on the right of the Commissioner or his collectors to examine the books of a taxpayer, but under the 1921 law[22] no tax can be assessed by the government after four years from the filing of the return (excepting with consent of the taxpayer) unless fraud is alleged.[23]

Procedure when tax is in jeopardy.—Section 250 (d) quoted on page 218 provides that in cases where the Commissioner believes that the collection of the tax will be jeopardized by the delay due to the appeal, he may make the assessment without giving notice or awaiting the conclusion of a final hearing. In such a case, if the collector will accept it, a claim for abatement may be filed.[24] If a claim is accepted, the collector will no doubt require a bond or security. The merits of the case would then be fought out under a claim in abatement. If the collector refuses to accept a claim in abatement, the tax must be paid and a claim for refund filed.[25]

Ruling. The probable run of the statute of limitations against the Government as a result of which it would be precluded from bringing suit or proceedings against the taxpayer constitutes jeopardy within the meaning of section 250 (d) of the Revenue Act of 1921 and under such circumstances the Commissioner may assess the tax without giving the notice or awaiting the conclusions of the hearing provided for in said section. (C. B. I-1, page 305; I. T. 1333.)

The courts will no doubt have an opportunity to pass on this question. There is some question about the foregoing ruling being correct. What did Congress intend? Does the setting of the sun on a particular day constitute jeopardy?

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in the waivers is "unreal." Another criticism of the waiver is vagueness of the persons bound or the promisees. Their identity and authority are not disclosed.

[22] Section 250(d).

[23] Section 250(d) also provides that the assessment must be made within five years, for taxes applicable to years prior to 1921.

[24] See Art. 1006, page 211.

[25] *Ibid.*

Congress no doubt had in mind bankruptcy, concealment of assets to evade taxes, departure of taxpayer and the like.

Can assessments be made if taxpayer has not been properly notified?—Section 250 (d) specifically provides that in the case of an additional assessment

. . . . the taxpayer shall be notified thereof and given a period of not less than thirty days after such notice is sent by registered mail in which to file an appeal. . . . . Opporunity for hearing shall be granted and a final decision thereon shall be made as quickly as practicable. . . . .

The foregoing section applies to the 1916, 1917, 1918, and 1921 laws. Therefore, any assessment made after November 23, 1921, the date of enactment of the 1921 law, is illegal if the above section has not been followed.[26]

Additional assessments bear interest.—The assessment bears interest from the date the tax was due.[27]

LAW. Section 250. . . . . (b) . . . . If the amount already paid is less than that which should have been paid, the difference, to the extent not covered by any credits due to the taxpayer under section 252 (hereinafter called "deficiency"), together with interest thereon at the rate of one-half of 1 per centum per month from the time the tax was due (or, if paid on the installment basis, on the deficiency of each installment from the time the installment was due), shall be paid upon notice and demand by the collector. . . . .

The foregoing provision applies only to returns for 1921 and subsequent years.

Assessment when consolidated returns are filed.—

LAW. Section 240. . . . . (b) In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement,

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[26] The Treasury has ruled that where an assessment was made prior to this date the taxpayer is not entitled to the benefit of this provision. (C. B. I-1, page 305; I. T. 1200.)

[27] [Former Procedure] The earlier rule was to charge interest only if not paid within 10 days after receipt of notice and demand.

then on the basis of the net income properly assignable to each. There shall be allowed in computing the income tax only one specific credit computed as provided in subdivision (b) of section 236.

The foregoing formula for apportionment of taxes is modified in the following in the case of consolidated returns for 1917 filed by corporations and partnerships:

RULING. It is held, therefore, that where corporations and partnerships are consolidated the excess profits tax should be allocated to the partnerships as a group according to the invested capital and net income assignable to the partnership group. After the proper amount of the excess profits tax has been allocated to the partnership group, article 78 may then be applied within the partnership group as it is now applied within the corporation group. (C. B. I-1, page 295; L. O. 1083.)

Final determination and assessment.—The law provides that a case, under certain conditions, may be finally determined, thus overcoming the uncertainty which has heretofore existed as to when a tax case was actually closed.

LAW. Section 1312. That if after a determination and assessment in any case the taxpayer has without protest paid in whole any tax or penalty, or accepted any abatement, credit, or refund based on such determination and assessment, and an agreement is made in writing between the taxpayer and the Commissioner, with the approval of the Secretary, that such determination and assessment shall be final and conclusive, then (except upon a showing of fraud or malfeasance or misrepresentation of fact materially affecting the determination or assessment thus made) (1) the case shall not be reopened or the determination and assessment modified by any officer, employee, or agent of the United States, and (2) no suit, action, or proceeding to annul, modify, or set aside such determination or assessment shall be entertained by any court of the United States.

The foregoing applies to all the various kinds of taxes. A question may arise as to whether this section applies only to the 1921 law. The language is broad enough, in the opinion of the author, to cover all previous laws.

To bring about such a final determination, there must be (1) an agreement in writing between the taxpayer and the Commissioner, and (2) the agreement must be approved by the Secretary of the Treasury. In case of a corporation a certified

copy of the minutes of the board of directors authorizing an officer to sign the agreement must be filed with the Treasury. The agreement should be executed in duplicate. (See article 1141).

Aside from the general question as to whether the foregoing section is constitutional, a question may arise as to its breadth. What is meant by "after a determination and assessment *in any case* . . . . *the case* shall not be reopened"? What do the words "in any case" and "the case" include?

Generally speaking, the words "any case" or "the case" include only those particular questions under consideration. Such an interpretation would make invalid any agreement between the taxpayer and Commissioner to the effect that no question would be raised by either with reference to the tax return for any particular year or years. The law does not refer to tax returns or years.

In interpreting these words, the facts which confronted Congress when this section was written should be borne in mind. Taxpayers had complained that they never knew that their tax cases, meaning tax returns, had been finally closed. Arguments had been advanced that this fact had prevented many business transactions. It is possible that Congress realized that the subject of such a broad agreement would be too indefinite and vague, and therefore not legal.

When taxpayers wish to enter into an agreement under section 1312, a formal request should be addressed to the Commissioner.

Ruling. In connection with the closing of cases under section 1312 taxpayers are required to obtain a statement from the local collector of internal revenue showing the amount of taxes paid for the period to be closed by the agreement. This requirement has been made in the interest of expeditious action on taxpayers' requests for agreements in view of the fact that the Bureau is not in possession of the record as to payments, this matter being recorded only in the offices of the local collectors. The taxpayer is usually in the possession of complete data as to the total payments made by years and by tabulating them in such manner as to permit the collector's office to verify them promptly the entire proceeding is very materially expedited. (I-33-460; I. T. 1421.)

FORMS OF AGREEMENT BETWEEN COMMISSIONER AND TAXPAYER.—An agreement may be made under the following conditions:

1. Where an assessment has been paid without protest,
2. Where an assessment has been made and the Commissioner has abated the tax in part or in full,
3. Where an assessment has been made and the Commissioner has credited the tax in part or in full,
4. Where the Commissioner has allowed a refund.

Case 1 is covered by form A, which is as follows:

FORM "A" (734M)

THIS AGREEMENT, made this..............day of............. ...., 19 , under and in pursuance of Section 1312 of the Revenue Act of 1921, by and between.......... .... a taxpayer residing at . . . . having its principal office or place of business at .... and the COMMISSIONER OF INTERNAL REVENUE, with the approval of the SECRETARY OF THE TREASURY:

WHEREAS, There has been a determination and assessment of..... ....($.......) as the amount of tax ....penalt........due the United States of America from said taxpayer on account of.., and,

WHEREAS, said taxpayer has without protest paid in whole the amount of tax....... penalt....... so determined and assessed.

NOW, THIS AGREEMENT WITNESSETH: That said taxpayer and said COMMISSIONER OF INTERNAL REVENUE, with the approval of the SECRETARY OF THE TREASURY, hereby mutually agree that such determination and assessment shall be final and conclusive.

IN TESTIMONY WHEREOF, the parties to these presents have hereunto set their hands and seals the day and year first above written.

	....
	TAXPAYER
Signed, sealed and delivered in the presence of:	BY ....
	....
	COMMISSIONER
....	
....	APPROVED:
	....
	SECRETARY

(Note. Strike out inapplicable language.)

Case 2 is covered by form B, which is the same as form A except immediately after the colon at the end of the first paragraph the following should be substituted:

Form "B" (735M)

. . . .

Whereas, on or about the....................day of........ ...., 19..., there was assessed against the taxpayer the sum of........................($.........), as the amount of tax.... penalt.... due the United States of America from the taxpayer on account of.. ...., and,

Whereas, There has been a determination by the Commissioner that the sum of........................($.........) is the correct amount of tax.... penalt.... due the United States of America from the taxpayer on account of said...................................., and,

Whereas, The Commissioner has made an abatement, based on such determination and such assessment, of the sum of............ ....($.........) and the taxpayer has accepted such abatement;

Now, This Agreement Witnesseth: That the taxpayer and the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, hereby mutually agree that such determination of the sum of..........................($.........) as the correct amount of tax.... penalt.... due from the taxpayer on account of said... and such assessment as abated in accordance with such determination, shall be final and conclusive.

In Testimony Whereof . . . .

Case 3 is covered by form C, which is the same as form A except immediately after the colon at the end of the first paragraph the following should be substituted:

Form "C" (736M)

. . . .

Whereas, on or about the....................day of......... ...., 19...., there was assessed against the taxpayer the sum of...................................($........) as the amount of tax.... due the United States of America from the taxpayer on account of.., and,

Whereas, the taxpayer, pursuant to such assessment, on or about the.....................day of.................., 19..., paid the sum of.............................($........) as tax.... due the United States of America on account of said.............. ...., and,

Whereas, there has been a determination by the Commissioner that the sum of..............................($........) is the correct amount for which the taxpayer was liable on account of said ...., and,

Whereas, the Commissioner has made a credit, based on such determination and such assessment, of the sum of.................................... ($........) against tax.... due from the taxpayer on account of.. ....
and the taxpayer has accepted such credit;

Now, This Agreement Witnesseth: That the taxpayer and the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, hereby mutually agree that such determination of the sum of..........................($........) as the correct amount of tax.... for which the taxpayer was liable on account of said..
and such assessment as reduced by the amount credited as aforesaid, shall be final and conclusive.

In Testimony Whereof . . . .

Case 4 is covered by form D, which is the same as form A except immediately after the colon at the end of the first paragraph the following should be substituted:

Form "D" (737M)

. . . .

Whereas, on or about the......................day of...... ...., 19...., there was assessed against the taxpayer the sum of..........................($........) as the amount of tax.... penalt.... due the United States of America from the taxpayer on account of................................... ...., and,

Whereas, the taxpayer, pursuant to such assessment, on or about the............................ day of.........., 19...., paid the sum of..........................($........) as tax.... penalt.... due the United States of America on account of said ...., and,

Whereas, There has been a determination by the Commissioner that the sum of.............................($........) is the correct amount for which the taxpayer was liable on account of said..., and,

Whereas, The Commissioner has made a refund, based on such determination and such assessment, of the sum of.................. ....($........), and the taxpayer has accepted such refund;

Now, This Agreement Witnesseth: That the taxpayer and the Commissioner of Internal Revenue, with the approval of

the SECRETARY OF THE TREASURY, hereby mutually agree that such determination of the sum of..........................($........) as the correct amount of tax......penalt......for which the taxpayer was liable on account of said.............................. and such assessment as reduced by the amount refunded as aforesaid, shall be final and conclusive.

IN TESTIMONY WHEREOF . . . .

Final determination of claims.—It is difficult to distinguish the following provision from section 1312:

LAW. Section 1313. **That in the absence of fraud or mistake in mathematical calculation, the findings of facts in and the decision of the Commissioner upon (or in case the Secretary is authorized to approve the same, then after such approval) the merits of any claim presented under or authorized by the internal-revenue laws shall not be subject to review by any other administrative officer, employee, or agent of the United States.**

The foregoing section falls under that division of the law which Congress terms "Administrative Review." It is the only section under this division and follows immediately section 1312. The language of section 1312, which states that "the case shall not be reopened or the determination and assessment modified by any officer, employee, or agent of the United States," should be broad enough to stop all administrative review.

It is possible, notwithstanding the heading, that Congress intended this section to apply only to claims filed by the taxpayer. Section 1312 is confined to "a determination and assessment in any case the taxpayer has without protest paid in whole any tax . . . . or accepted any abatement, credit, or refund based on such determination and assessment." It is possible that section 1312 is intended to apply to cases initiated by the government, and section 1313 to cases initiated by the taxpayer.

It is significant that the conference committee inserted the word "other" immediately before the phrase "administrative officer, employee, or agent of the United States."

When may the Government reopen a case?—The following decision[28] is of interest in connection with cases which have been closed under laws prior to the 1921 law. It will also be of interest in connection with sections 1312 and 1313. The courts will no doubt insist upon a strict application of these sections.

Decision. . . . . No authority has been vested in a commissioner to overrule and reverse the action of his predecessor in office. Commissioner Osborne, acting under his authority, heard and determined a question of fact necessary to enable him to act intelligently in ascertaining and determining the amount of plaintiff's net income on which he would be required to make the levy and assessment, and his finding on that issue not having been impeached by the answer should, under every principle and rule of law, be regarded here as final. . . . .

There is no doubt that an allowance by the Commissioner may be impeached anywhere for fraud, for that avoids all contracts into which it enters as against the party defrauded; or for want of jurisdiction, or for a mistake apparent upon the certificate of allowance; or generally for such other irregularities in the proceedings as would avoid an award made by arbitration so far as the proceedings are similar; but not for what might seem to others to be a mere mistake of judgment in the weighing and giving force and effect to evidence.

Procedure to reopen a case.—The following ruling applies to cases which have been finally settled by the Treasury. It does not apply to cases closed under sections 1312 and 1313 of the 1921 law.

Ruling. Where any case in the Bureau of Internal Revenue has been finally closed after the taxpayer, or other party thereto, has had a hearing or has been afforded by written notice an opportunity to present oral or written arguments or statements of fact in support of his contentions, the case will not be reopened except (1) where a showing is made of new and material facts, accompanied by an explanation, satisfactory to the Commissioner of Internal Revenue, of the failure to produce such facts prior to the closing of the case, or (2) where the case is materially affected by the change of regulations or by the final decision of another case either by the Commissioner of Internal Revenue or by a court of competent jurisdiction. The application for reopening a case should be addressed to the Commissioner of Internal Revenue, should state succinctly the facts and

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[28] *Penrose v. Skinner,* 278 Fed. 284.

circumstances upon which the application is based, and must be supported by the affidavit of a person having knowledge of the facts.

This decision is not to be construed as modifying the regulations relating to the filing of claims in abatement or claims for refund, nor as denying the right of a taxpayer to a hearing or to an appeal at any stage of his case until the case has been finally closed. After the taxpayer has exhausted his remedies within the Bureau, however, and the case has been finally closed, it will be reopened only under the conditions stated in the decision. (C. B. 5, page 313; T. D. 3240.)

Procedure in cases arising prior to T. D. 3269.—Prior to the passage of the 1921 law (November 23, 1921) and the issuance of T. D. 3269,[29] it was contrary to the policy of the Treasury to permit an appeal to Committee before assessment. That is, a proposed assessment was not withheld pending an appeal. Consequently, there are now many cases pending before the Committee on Appeals and Review. There are others which have been assessed and formal appeal not yet made. The present procedure should not affect any of these cases.

Taxpayers were advised to file claims in abatement pending an appeal,[30] and collectors should be notified by the Secretary of the Treasury to postpone any action looking to collection until final decisions by the Committee are handed down.

Claims procedure.—The procedure of the Treasury should provide for an orderly appeal to the Commissioner in cases where the Unit has ruled adversely on a claim for abatement, refund or credit. Heretofore in the case of claims for abatement and credit, taxpayers did not know that their claims were denied by the Unit until collectors demanded payment.

In view of the provisions of the 1921 law, all decisions of the Unit should be sent to taxpayers and their right to dissent and appeal made clear.

A rule should be made that taxpayers be notified by letter that the Unit has rejected their claims and that they

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[29] This T. D. was incorporated in Art. 1006 as originally issued.
[30] C. B. 3, page 370; O. D. 709.

have, say, thirty days, to give notice of appeal to the Commissioner. If notice of appeal is not filed, collectors may reasonably demand payment in case of rejected claims for abatement or credit.

Until such a rule is promulgated, taxpayers should notify the Treasury when claims are filed that if the decision of the Unit is adverse, the right of appeal to the Commissioner is requested before the claims are formally rejected.

Summary proceedings in case of contemplated evasion.—

LAW. Section 250. . . . . (g) If the Commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be brought without delay, the Commissioner shall declare the taxable period for such taxpayer immediately terminated and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In any action or suit brought to enforce payment of taxes made due and payable by virtue of the provisions of this subdivision the finding of the Commissioner, made as herein provided, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design. A taxpayer who is not in default in making any return or paying income, war-profits, or excess-profits tax under any Act of Congress may furnish to the United States, under regulations to be prescribed by the Commissioner with the approval of the Secretary, security approved by the Commissioner that he will duly make the return next thereafter required to be filed and pay the tax next thereafter required to be paid. The Commissioner may approve and accept in like manner security for return and payment of taxes made due and payable by virtue of the provisions of this subdivision, provided the taxpayer has paid in full all other income, war-profits, or excess-profits taxes due from him under any Act of Congress. If security is approved and accepted pursuant to the provisions of this subdivision and such further or other security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment

of such taxes shall not be enforced by any proceedings under the provisions of this subdivision prior to the expiration of the time otherwise allowed for paying such respective taxes.[31] In the case of a citizen of the United States about to depart from the United States the Commissioner may, at his discretion, waive any or all of the requirements placed on the taxpayer by this subdivision. No alien shall depart from the United States unless he first secures from the collector or agent in charge a certificate that he has complied with all the obligations imposed upon him by the income, war-profits, and excess-profits tax laws. If a taxpayer violates or attempts to violate this subdivision there shall, in addition to all other penalties, be added as part of the tax 25 per centum of the total amount of the tax or deficiency in the tax, together with interest at the rate of 1 per centum per month from the time the tax became due. . . . .

Congress wisely empowered the Commissioner, in cases of intent to evade, to declare all taxes to be due and payable.

Persons going abroad must present certificates of compliance.—

Ruling. In order to obtain income tax clearance, American citizens planning to leave the United States are required to present their certificates of compliance or receipts showing payment of income tax, at the office of the internal revenue agent in charge at the port of embarkation, rather than to the internal revenue agent at the pier. (C. B. 3, page 301; O. D. 666.)

This ruling was issued under the 1918 law. The present law gives the Commissioner power to waive this requirement as to citizens of the United States and it is waived.

Aliens departing from the United States must present evidence that they have satisfied their income tax obligations. Detailed procedure is set forth in Chapter XLI, "Non-Resident Aliens." Many aliens when leaving the United States are classed as non-residents.

Payment

Payment may be made in instalments.—The law permits the taxpayer either to divide his tax into four instalments,

[31] The portion of this subdivision following this point was added to the provision of the 1918 law.

spread evenly throughout the year,[32] or to pay it in a lump sum at the time of filing the return.

Law. Section 250. (a) That except as otherwise provided in this section and sections 221 and 237 [payment at the source] the tax shall be paid in four installments, each consisting of one-fourth of the total amount of the tax. The first installment shall be paid at the time fixed by law for filing the return,[33] and the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after the time fixed by law for filing the return. Where an extension of time for filing a return is granted the time for payment of the first installment shall be postponed until the date of the expiration of the period of the extension, but the time for payment of the other installments shall not be postponed unless the Commissioner so provides in granting the extension. In any case in which the time for the payment of any installment is at the request of the taxpayer thus postponed, there shall be added as a part of such installment interest thereon at the rate of ½ of 1 per centum per month from the time it would have been due if no extension had been granted, until paid. If any installment is not paid when due, the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector.

The tax may at the option of the taxpayer be paid in a single payment instead of in installments, in which case the total amount shall be paid on or before the time fixed by law for filing the return, or, where an extension of time for filing the return has been granted, on or before the expiration of the period of such extension.

It should be noted particularly that the extension of time for filing the return ordinarily operates to extend the time of payment of the first instalment only.[34]

Ruling. Where an understatement of the tax in a return is not attributable to negligence or fraud and a taxpayer accordingly fails to pay at least one quarter of the tax due at the time for filing the return, he does not lose his right to make installment payments. (C. B. 4, page 317; Digest O. D. 961.)

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[32] **[Former Procedure]** Under the 1909 and 1913 laws the entire amount of the tax was due June 30; under the 1916 and 1917 laws the tax was due June 15.

[33] The fifteenth day of the third month following the close of the taxable year—March 15 in case the calendar year is used.

[34] **[Former Procedure]** Extension of time for making a return formerly did not operate to postpone the payment of the tax. If an extension carried beyond the regular date of payment, the tax was payable "upon notice and demand." (Reg. 33, 1918, Art. 230.)

Notice of payment due.—The law states that the tax "shall be paid" at dates fixed by section 250 (a) quoted above, but penalties cannot be imposed until notice and demand has been made in accordance with the following:

LAW. Section 250. . . . . (e) . . . . In the case of the first installment provided for in subdivision (a) the instructions printed on the return shall be sufficient notice of the date when the tax is due and sufficient demand, and the taxpayer's computation of the tax on the return shall be sufficient notice of the amount due. In the case of each subsequent installment the collector may, within thirty days and not later than ten days before the installment becomes due, mail to the taxpayer notice of the amount of the installment and the date on which it is due for payment. Such notice of the collector shall be sufficient notice and sufficient demand under this section. . . . .

Subdivision (h) of this section makes this change retroactive with respect to the 1917 and 1918 laws.

If taxpayers wait for notice from the collector on the second and third instalments they run the risk of being called upon to pay all the remaining instalments at once, for subdivision (a) of section 250, which fixes the dates when the instalments must be paid, provides that "if any installment is not paid when due, the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector." In the case of the fourth instalment taxpayers can postpone payment until they receive notice in accordance with section 250 (e) without incurring this risk. However, in no case can penalty or interest be assessed until proper notice has been given.

ADDITIONAL NOTICE IN CASES OF ABSENCE.—In special cases where, for causes such as absence, there is delay in receiving mail, additional time is allowed.

REGULATION. . . . . By reason, however, of the absence from home or place of business in a foreign country or in the military or other service of the country and the consequent delay in receiving mail, or by reason of the location of the residence of an individual or of the office of a corporation to which the notice was addressed at a distance from the collector's office, it is frequently impossible for a

taxpayer to receive notice and demand and to make payment of the tax so that such payment may be received by the collector within the 10-day period (following the service of notice and demand). In all such cases the collector will enter on the notice as the date on which the tax becomes due and payable a date as nearly as possible 10 days after the time that the notice should be received in the ordinary course of the mails by the taxpayer. In such cases where it is established that a remittance for the tax was placed in the mails within the 10-day period after the due date specified in the notice, and tardiness was occasioned because the notice was not delivered in due time by reason of delay in the mail and satisfactory evidence of that fact is furnished, the penalty and interest will not be collected. (Art. 1007.)

Ruling. A taxpayer having filed his return and paid the first installment of tax is aware of his liability to pay the balance of the tax on the respective due dates, and failure to receive notice and demand for the payment of the later installments by reason of his absence from this country does not constitute a sufficient cause for waiving the penalty and interest on any installment of the tax not paid when due. (C. B. 2, page 236; O. D. 408.)

Notice required in all cases.—It appears that some collectors are too arbitrary in their demands for additional returns, collection of additional taxes, etc. Taxpayers may be assured that precipitate action is illegal. Reasonable notice of any proposed action must be given or the act is illegal, because it is in violation of the constitutional guarantee of due process of law.[35] The courts have held that as a general principle of law a proceeding for the assessment of property for taxation is judicial in its character, and in order to assure its validity the law authorizing it must provide some kind of notice.[36]

The law binds the Commissioner and the collectors to give ample notice of all proceedings, including the imposition of penalties. The notices must allow sufficient time to the taxpayer to produce evidence supporting his original returns, or to pay within the statutory time of 10 days after formal demand.

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[35] See Alex. M. Hamburg, "Limitations upon the Federal Taxing Power," *Bulletin of the National Tax Association*, Vol. III, pages 34-39.

[36] *County of Santa Clara v. Southern Pacific Railway Co.*, 18 Fed. 385; judgment affirmed, 118 U. S. 304, 30 L. Ed. 118, 6 Sup. Ct. 1132.

Method of calculating interest.—

Ruling. (a) Where interest is collectible at the rate of 1 per cent per month from the due date interest must be collected for the fractional part of a month where the tax is not paid within 10 days from notice and demand for payment.

(b) Under sections 502, 504, 629, 903, and 905,[37] interest is collectible at the rate of 1 per cent for each full month, and fractional parts of a month must be disregarded.

(c) Interest is collectible from the month tax becomes due. (C. B. 1, page 244; O. 884.)

Who pays the tax when a corporation liquidates?—

Regulations.[38] A corporation going into liquidation during any tax period may, at the time of such liquidation, prepare a "final return" covering the income received or accrued to it during the fractional part of the year during which it was engaged in business, and immediately file the same with the collector of the district in which the corporation has its principal place of business. Before distributing its assets, a dissolving corporation should reserve funds sufficient to pay any income tax assessable against it. Otherwise the tax may be collected by suit against the stockholders. . . . . (Reg. 33, 1918, Art. 205.)

When a corporation is dissolved, its affairs are usually wound up by a receiver or trustees in dissolution. The corporate existence is continued for the purpose of liquidating the assets and paying the debts, and such receiver or trustees stand in the stead of the corporation for such purposes. Any sales of property by them are to be treated as if made by the corporation for the purpose of ascertaining the gain or loss. . . . . (Art. 548.)

Ruling. Where a corporation dissolves and distributes all of its assets prior to the time the list carrying an assessment of additional tax against the corporation comes into the hands of the collector, the tax is not collectible upon notice and demand followed by distraint, but may be recovered only by means of a suit instituted against the stockholders or other persons who may have received the corporation's assets, except bona fide purchasers for a valuable consideration and creditors. (C. B. 4, page 324; O. D. 769.)

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[37] Section 502 relates to taxes due on transportation and telegraph, etc., service; section 504, to taxes due on insurance policies issued; section 629, to taxes due on soft drinks; sections 903 and 905, to taxes due on luxuries.
In the detailed ruling by the Treasury, it is stated: "Heretofore this office has held repeatedly that no interest for a fraction of a month shall be demanded."

[38] See C. B. 4, page 279; O. D. 821.

A federal court[39] has recently held that collection by distraint of taxes assessed by a collector ex parte against a long-since dissolved corporation, the business being continued by the former stockholders as a partnership (Pennsylvania), and the property against which the collector is proceeding being that of the partnership, may not be enjoined by the members of the partnership, they being taxable persons and the property itself being such as to be liable to distraint for any tax assessed against them.

It was held that a corporation which liquidated in 1916 before the passage of the 1916 law was nevertheless liable to taxation under that law.[40] Similarly the Treasury expressly declared that a corporation liquidating in 1918 or early in 1919 was subject to the rates imposed by the new act of 1918, even though it was not passed until 1919.

REGULATION. . . . . A corporation which was dissolved in 1921 prior to the enactment of the present statute is not relieved from the necessity of rendering returns thereunder for such portion of 1921 as elapsed before its dissolution. . . . . (Art. 621.)

It is, of course, important to consider the liability for taxes whenever a corporation liquidates, but it is difficult to provide for a liability so uncertain as that created by subsequent tax legislation. In *Brady v. Anderson*[41] the estate was not settled when the law of 1913 was passed. But a corporation which dissolved, say, in February, 1918, could hardly foresee the exact liability to be incurred under a law which was not passed until a full year later. In the meantime the corporation might have dissolved as it had a legal right to do. It was willing to set aside all taxes accrued under existing laws. To assess a tax in 1919 under a law passed in February, 1919, on a corporation which was dissolved in

[39] *Markle et al. v. Kirkendall,* 267 Fed. 498.

[40] *U. S. v. McHatton et al.,* 266 Fed. 602.

[41] 240 Fed. 665, 153 C. C. A. 463; certiorari denied 244 U. S. 654, 61 L. Ed. 1373, 37 Sup. Ct. 652. In that case the Brady estate was assessed on net income which accrued to Brady prior to his death when no income tax was in force.

February, 1918, would certainly appear to be reviving a dead corporation.[42]

RULING. Where a corporation dissolves and disposes of its assets without making provision for the payment of its accrued Federal income tax liability for the tax follows the assets so distributed, and upon failure to secure the unpaid amount suit to collect the tax should be instituted against the stockholders and other persons receiving the property, except bona fide purchasers for a valuable consideration. The penalties prescribed in section 253 of the Revenue Act of 1918 will attach to the principal officers of the corporation upon failure to comply with the provisions of that section. (C. B. 3, page 300; O. D. 597.)

The foregoing conforms with a recent court decision.

Stockholders of a corporation, who received in distribution the entire proceeds of its property on its dissolution in 1916, after payment of its federal excise tax, but before the passage of the Income Tax Act of September 8, 1916, increasing the amount of the tax on the net income of all corporations for that year, were held liable for the increased tax.[43]

A stockholder received a liquidating dividend in 1917. It was found that the distribution was excessive because federal taxes had not been sufficiently paid. Held, that the stockholder might file an amended return for 1917, deducting the assessment paid in 1920. (C. B. I-1, page 17; I. T. 1164.)

RECEIVERS PERSONALLY RESPONSIBLE—WHEN?—In the case of *Pennsylvania Cement Company v. Bradley Contracting Company* (274 Fed. 1003), receivers were directed not to declare a dividend to creditors before federal taxes had been adjusted, because they could be held personally responsible for the taxes under sections 3466 and 3467 of the Revised Statutes.

Delinquent assessment payable "upon notice and demand."—

LAW. Section 250. . . . . **(c) If the return is made pursuant**

[42] See "Retroactive legislation," page 23.
[43] *U. S. v. McHatton et al*, 266 Fed. 602.

to section 3176[44] of the Revised Statutes as amended, the amount of tax determined to be due under such return shall be paid upon notice and demand by the collector.

In all cases it must be remembered that the tax levied by the collectors must be paid if (after an appeal to the Commissioner) the assessment is confirmed, even if, in the opinion of the taxpayer it is clearly in error. The United States Supreme Court has held that Congress has afforded a complete and adequate remedy at law open to all persons aggrieved by the collection of an erroneous or illegal revenue tax, and that the taxpayer must pay the tax and may then bring an action to recover it after appeal.[45]

In a more recent case[46] the court granted the injunction and restrained the collector from proceeding under a distraint warrant.

Media of payment.—

PAYMENT MAY BE MADE BY MAILING UNCERTIFIED CHEQUES.—Taxes may be paid to the collector by cheque and should be mailed at least a day or two before the date fixed for payment. During the last few days of the payment period many taxpayers pay in person at the offices of the collectors, and this causes congestion and long delays. The use of the mails is, therefore, preferable and is on the whole trustworthy.

Until the enactment of the 1917 law, practically all taxes were paid by certified cheques. The law[47] now authorizes the collectors of internal revenue to accept uncertified cheques in payment of income and excess profits taxes. Cheques should be made payable to "Collector of Internal Revenue at (City), (State)" and be made collectible at par without deduction for exchange.

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[44] Section 3176 deals with the subject of false and fraudulent returns and is quoted on page 147.

[45] For a discussion of this subject see page 228.

[46] *du Pont v. Graham.* Fed. Dist. Ct., Delaware. Not yet reported.

[47] Section 1325. See also Art. 1733.

[Former Procedure] The 1917 law (section 1010) was the first to authorize collectors to accept uncertified cheques in payment of taxes. (See T. D. 2627 and 2666.)

RULING. A taxpayer who tenders a check whether certified or uncertified in payment for taxes is not released from his obligation until the check is paid. Where such a check is lost in the mails, a Collector of Internal Revenue is not required, as a condition precedent to the issuing of a duplicate check by a taxpayer, to furnish bond indemnifying him against possible loss in connection with the first check. (C. B. 3, page 371; O. D. 626.)

PAYMENTS IN TREASURY NOTES OR CERTIFICATES OF INDEBTEDNESS.—

LAW. Section 1325. **That collectors may receive, at par with an adjustment for accrued interest, notes or certificates of indebtedness issued by the United States . . . . in payment of income, war-profits and excess-profits taxes and any other taxes payable other than by stamp,[48] . . . .**

The purchase of certificates of indebtedness affords a convenient and economically sound method of providing in advance for taxes. They may be purchased at par, and bear interest at a fair rate. They mature at various dates. Taxpayers can accumulate the certificates, as funds are available, at any time before the tax payments are due and on the due dates present them with the tax bills. In the meantime interest will have accrued.

The Commissioner from time to time issues instructions relative to the acceptance of notes and certificates of indebtedness of the United States Government.

Commissioner may extend date of payment.—The law permits the Commissioner, under certain conditions, to extend the date of payment of additional assessments.

LAW. Section 250. . . . . **(f) In the case of any deficiency (except where the deficiency is due to negligence or to fraud with intent to evade tax) where it is shown to the satisfaction of the Commissioner that the payment of such deficiency would result in undue hardship to the taxpayer, the Commissioner may, with the approval of the Secretary, extend the time for the payment of such deficiency or any part thereof for such period not in excess of eighteen months**

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[48] **[Former Procedure]** With exception of the words "notes or" after the words "accrued interest," this section is the same as section 1314 of the 1918 law. This practice was begun in 1917. Section 1010, 1917 law.

from the passage of this Act as the Commissioner may determine. In such case the Commissioner may require the taxpayer to furnish a bond with sufficient sureties conditioned upon the payment of the deficiency in accordance with the terms of the extension granted. There shall be added in lieu of other interest provided by law, as a part of such deficiency, interest thereon at the rate of two-thirds of 1 per centum per month from the time such extension is granted; except where such other interest provided by law is in excess of interest at the rate of two-thirds of 1 per centum per month. If the deficiency or any part thereof is not paid in accordance with the terms of the extension granted, there shall be added as part of the deficiency, in lieu of other interest and penalties provided by law, the sum of 5 per centum of the deficiency and interest on the deficiency at the rate of 1 per centum per month from the time it becomes payable in accordance with the terms of such extension.

Subdivision (h) of this section provides that the above shall also apply to any assessments which may be made under the 1917 and 1918 laws.

Regulation. . . . . The term "undue hardship" means more than an inconvenience to the taxpayer. It is defined as meaning that substantial financial loss or sacrifice will result to the taxpayer from making payments of the deficiency at the due date.

. . . . No extension of time may be granted under subdivision (f) of section 250 for the payment of any regular installment of tax due as shown by the original return of the taxpayer.

Any application for the extension must be made under oath on Form 1127[49] in accordance with instructions printed thereon and must be accompanied by evidence showing that undue hardship to the taxpayer would result if the extension were refused. The extension will not be granted on a general statement of hardship, but in each case there must be furnished a statement of the specific facts showing what, if any, financial loss or sacrifice will result if the extension is not granted. The application should, wherever practicable, contain a certified statement of assets and liabilities of the taxpayer.

The application, with the evidence, must be filed with the collector, who will at once transmit it to the Commissioner with his recommendations as to the extension. When it is received by the Commissioner it will be examined and within thirty days either rejected or tentatively approved.

Where the application is tentatively approved and a bond is required it must be filed with the collector within 10 days after the notification by the Commissioner that a bond is required. It shall be

[49] See Appendix B, of *Income Tax Procedure*, 1922.

conditioned for the payment of the deficiency and applicable penalties, if any, and interest in accordance with the terms of the extension to be granted and shall be executed by a surety company holding a certificate of authority from the Secretary of the Treasury as an acceptable surety on Federal bonds and shall be subject to the approval of the Commissioner. In lieu of such a bond the taxpayer may file a bond secured by deposit of Liberty bonds or other bonds or notes of the United States equal in their total par value to the amount of the deficiency and applicable penalties, if any, and interest, as provided in section 1329 of the Revenue Act of 1921. (Art. 1014.)

If collectors insist on surety bonds in all cases, the "relief" will be barren because most taxpayers who cannot pay are also unable to comply with the requirements of surety companies. If taxpayers are able to furnish bond, that fact alone should make the filing of bonds unnecessary. The United States has a first lien on the property of taxpayers and this is reasonable protection. It is not fair to creditors whose claims are subordinate, that surety bonds be demanded when taxpayers are unable to furnish them.

RULINGS. A taxpayer protests against an additional assessment of tax for 1919 by filing a claim for abatement, and also requests an extension of time to make payment under the provisions of section 250. Held, that where a taxpayer has not conceded the correctness of the tax assessed, a request for an extension of time to make payment is not in order. (C. B. I-1, page 311; I. T. 1290.)

Section 250 (f) of the Revenue Act of 1921 is applicable to deficiencies of income and excess profits tax under the Revenue Act of 1917 and the Revenue Act of 1918 not yet paid although assessment was made prior to November 23, 1921. (C. B. I-1, page 310; I. T. 1199.)

. . . . Section 250 (f) is a relief provision and should be given a liberal rather than a strict, construction. There is no element of bad faith present in connection with the returns of this company, nor is negligence to be imputed. It is believed that a deficiency in tax within the meaning of the Act appears as well in those cases where no tax was shown by the face of the returns as in a case where less than the correct amount appears. In the instant case the members of the corporation have undoubtedly reported in their personal returns the profits of the M Company and have already paid a tax thereon. Having in good faith reported as a personal service corporation, and the Bureau having disallowed that classification and as a corporation found them subject to a certain tax, the tax so found is believed to be a deficiency

within the meaning of the Act and the Commissioner may in his discretion extend the time within which to make payment of the same. (I-32-453; I. T. 1417.)

Receipts for taxes paid.—The law requires collectors to give receipts only when requested to do so by taxpayers.

LAW. Section 251. That every collector to whom any payment of any tax is made under the provisions of this title shall upon request give to the person making such payment a full written or printed receipt, stating the amount paid and the particular account for which such payment was made; and whenever any debtor pays taxes on account of payments made or to be made by him to separate creditors the collector shall, if requested by such debtor, give a separate receipt for the tax paid on account of each creditor in such form that the debtor can conveniently produce such receipts separately to his several creditors in satisfaction of their respective demands up to the amounts stated in the receipts; and such receipt shall be sufficient evidence in favor of such debtor to justify him in withholding from his next payment to his creditor the amount therein stated; but the creditor may, upon giving to his debtor a full written receipt acknowledging the payment to him of any sum actually paid and accepting the amount of tax paid as aforesaid (specifying the same) as a further satisfaction of the debt to that amount, require the surrender to him of such collector's receipt.

RULING. . . . . Receipts are documents required by provisions of the internal revenue laws and by regulations made in pursuance thereof, within the meaning of section 3451, Rev. Stat., making it an offense to simulate or falsely or fraudulently execute or sign any document required by the internal revenue laws, or any regulation made in pursuance thereof, or to procure the same to be falsely or fraudulently executed, or to advise, aid in, or connive at such execution thereof. . . . .

The offense may be committed either where the receipt itself is a genuine receipt of the kind kept for that purpose in the office of the internal revenue collector but signed by the defendant without authority, or where, even if not a blank of the kind required to be kept, the blank itself is simulated or falsely or fraudulently executed and issued by a person who has no power or authority to do so. . . . . (T. D. 2874, June 23, 1919.)

The author is informed that some taxpayers have not received receipts although specific requests were made for them, and that such failure has caused great inconvenience when taxpayers have gone abroad or have filed claims for refund.

The law is explicit on the point and collectors have no right to insist, as some have done, that a paid cheque is all the taxpayer may ask. If receipts are not available to accompany claims, photostatic copies of paid cheques are convenient substitutes.

Payment Under Protest

Payment under protest unnecessary to support claim for refund.—In no event is it necessary to pay under protest to secure a legal right to demand a refund when it is believed that the tax has been erroneously assessed.[50] Section 3220 of the Revised Statutes specifically covers this point. The intention of the law is that no one shall be erroneously or excessively taxed. This intention is respected by the Commissioner of Internal Revenue. Sometimes his subordinates or persons in the offices of the collectors, acting with more or less praiseworthy zeal, treat a taxpayer's claim as if it were an attempt to extract money from the United States Treasury under false pretenses. Anyone with a legitimate claim might just as well convey the impression that the United States Treasury retains some of his money, collected under false pretenses.

Both positions are wrong. The claim and its consideration should be as free from technicalities as possible and be made and treated as impartially as a business transaction. The whole matter should be as simple as the filing with a railroad company of a claim for refund of an overcharge. Business men who do not hesitate to make these claims against railroad companies, are often unwilling to insist upon the return of overpaid taxes.

It has been recommended by some authorities that all taxes reported, whether in any case they are more or less than the correct amount, should be paid under protest, not in order to

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[50] It is, however, always wise to do so because the taxpayer may wish to institute suit. See page 255.

acquire any right to claim a refund (that being possible without question), but to establish a perfect foundation for a suit against the collector if the claim for refund is rejected. The theory is that if payment is made voluntarily, in full knowledge that the tax is erroneous, the taxpayer is estopped from any right to succeed in an action at law.

If, as stated elsewhere, payment has been made without any knowledge of the illegality of the assessment, an action can be maintained for that reason. Furthermore, even where a claim has been made for abatement (before paying the tax) and it is refused, and notice is served by the collector that the tax must be paid or penalties will be enforced, it is evident that the payment is being made not voluntarily, but under duress, and the courts hold that collections in such circumstances do not estop the payer from subsequent action at law.

Form of payment under protest.—In the case of an additional assessment after examination, where the facts upon which the government bases its claims are, in the opinion of the taxpayer, unfounded and illegal when making the payment, a simple form of protest should be attached, e. g.:

I hereby protest against the assessment of the tax levied against me as evidenced in notice dated ...., on the ground that it is erroneous and illegal, and payment is hereby made solely to prevent the imposition of penalties threatened and the attachment of my property.

Protest not necessary when payment was made under mistaken Treasury regulations.—In one class of cases it certainly is not necessary to have paid under protest—that is, where a taxpayer prepared his returns in accordance with Treasury regulations, believing them to be correct, and having been assessed thereon paid the tax in due course.

In the cases of *Greenport Basin and Construction Company v. United States,* and *Young v. United States,*[51] the court said, after quoting section 252 of the 1918 law, that:

[51] 269 Fed. 58.

DECISION. Under the act, therefore, the refund is a matter of right, without proof of duress or protest. It has been so held under a similar statute. *U. S. v. Hvoslef,* 237 U. S. 1, 35 Sup. Ct. 459, 59 L. Ed. 813, Ann. Cas. 1916A, 286.

Even if it were necessary to plead duress or protest, the petition or complaint sets forth that the defendant computed the tax under compulsion of the regulations and filed a claim for abatement of the taxes assessed before payment. This complies with every requisite of a payment under protest. *Chesebrough v. U. S.,* 192 U. S. 253, 24 Sup. Ct. 262, 48 L. Ed. 432; *City of Philadelphia v. Collector,* 5 Wall. 720, 18 L. Ed. 614. The government urges that it is necessary to make a protest at the time of actual payment, but it seems to the court that this would be a useless requirement. The objects of the protest are to define the taxpayer's attitude and to notify the government thereof. These have been fully accomplished by the objection of the taxpayer when the computation was made and by the filing of his claim.

Proof of involuntary payments required in certain actions at law.—While involuntary payment need not be made under protest in order to secure a refund in the manner provided by the act, in cases where recovery of taxes alleged to be illegally exacted is sought by an action at law, the federal courts have held that the claimant must show involuntary payment. In *City of Philadelphia v. Diehl, Collector,*[52] the United States Supreme Court said:

DECISION. Where the party voluntarily pays the money, he is without remedy; but if he pays by compulsion of law, or under protest, or with notice that he intends to bring suit to test the validity of the claim, he may recover it back, if the assessment was erroneous or illegal, in an action for money had and received.

In *Elliott v. Swartwout,*[53] the court said:

DECISION. It is therefore to be considered as a voluntary payment, by mutual mistake of law; and, in such case, no action will lie to recover back the money. The construction of the law is given to both parties, and each presumed to know it. Any instructions from the treasury department could not change the law, or affect the rights of the plaintiff. He was not bound to take, and adopt that construction. He was at liberty to judge for himself, and act accordingly.

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[52] 5 Wall. 720, 72 U. S. 720, 18 L. Ed. 614.
[53] 35 U. S. 137, 12 Curtis 46, 9 L. Ed. 373.

. . . . There can be no hardship in requiring the party to give notice to the collector that he considers the duty illegal, and put him on his guard, by requiring him not to pay over the money. The collector would then be placed in a situation to claim an indemnity from the government. But if the party is entirely silent, and no intimation of an intention to seek a repayment of the money, there can be no ground upon which the collector can retain the money, or call upon the government to indemnify him against a suit. It is no sufficient answer to this that the party cannot sue the United States. The case put in the question, is one where no suit would lie at all. It is the case of a voluntary payment under a mistake of law, and the money paid over is to the treasury; and if any redress is to be had, it must be by application to the favor of the government, and not on the ground of a legal right.

The court held that in case of mistake of law, protest was necessary to suit. In case of mistake of fact, such protest was not necessary. It should be noted that the foregoing case was decided in 1836.

A recent decision holds:

Decision. . . . . It appears from the comp'aint, to which defendant demurred, that the money for the recovery of which suit was brought was paid voluntarily in March, 1919, as and for a part of plaintiff's income tax for the year 1918. The item of loss, upon account of which plaintiff now believes himself entitled to a refund, was not called to the attention of any Government official prior to March, 1921. The original tax having been transmitted to the Treasury without protest or complaint upon the part of plaintiff, it seems to me that as against the collector there could be no recovery at common law, nor under the statutes relating to him or his office.

It is possible that plaintiff has some rights granted to him under the provisions of section 252 of the Revenue Act of 1918, but if so, I am of opinion that such right can not be asserted in a suit against the collector who received plaintiff's voluntary payment in 1918. Judgment may be entered sustaining the demurrer of defendant and dismissing the complaint.

On Rehearing.

It is my judgment that there is nothing in section 252 of the Revenue Act upon which plaintiff relies which relieves him from the effect of having voluntarily paid an amount of tax against which he might have offset a bad debt. The tax was paid by plaintiff with full knowledge of all the facts, and without any interposition of the Government or any of its officials, and to hold that a taxpayer is entitled for years after the payment of a tax to harass and annoy the

taxing officials and the courts as to the unwisdom, unpropriety, or oversight of what he himself did, when under no coercion and compulsion upon the part of the Government, is something I am unwilling to do. As to the purpose and effect of section 252 of the Revenue Act see Holmes Federal Taxes, 1922 edition, page 890. The order heretofore mentioned herein will stand.[54]

This case was not seriously pressed. The plaintiff let the case go by default and did not even submit a brief. He did, however, come in for a hearing after the court had intimated that a protest might not be necessary. This case can not be accepted as being final on this question. When the question is considered seriously in the light of the complicated income and excess profits tax laws, the courts may take a more liberal view. In the foregoing case the court stated that "the tax was paid by the plaintiff with full knowledge of all the facts, and without any interposition on the part of the Government." It can hardly be said that any income tax has been paid with a full knowledge of all the facts. When due dates for returns arrive, taxpayers do their best to prepare correct returns. The old rule of protest grew up under tax laws radically different from the present complicated, and almost confiscatory, income and excess profits tax laws.

Arguments in favor of paying under protest.—Although the Treasury unreservedly states that a tax, if excessive, need not have been paid under protest to be recovered, there are certain cases which indicate that a taxpayer should pay under protest to protect his right to sue for refund. They are, however, not entirely clear and it will be found that the modern tendency is to waive the formal protest.

The following cases are illustrative of past practice:

Wright v. Blakeslee, 101 U. S. 174, 25 L. Ed. 1048 (1880) holds that, although no written notice or protest is required by statute of a party paying illegal taxes under the internal revenue laws, in order to recover the amount erroneously paid, he must, however, pay under protest in some form, or his payment will be deemed voluntary.

[54] *Fox v. Edwards,* United States District Court, Southern District of New York. (C. B. I-1, page 401; T. D. 3308.)

As stated by Chief Justice Fuller, in *Chesebrough v. United States:*[55]

Decision. The rule is firmly established that taxes voluntarily paid cannot be recovered back, and payments with knowledge and without compulsion are voluntary. At the same time, when taxes are paid under protest that they are being illegally exacted, or with notice that the payer contends that they are illegal and intends to institute suit to compel their repayment, a recovery in such suit may, on occasion, be had, although generally speaking, even a protest or notice will not avail if the payment be made voluntarily, with full knowledge of all the circumstances, and without any coercion by the actual or threatened exercise of power possessed, or supposed to be possessed, by the party exacting or receiving the payment, over the person or property of the party making the payment, from which the latter has no other means of immediate relief than such payment.

In *Herold v. Kahn,*[56] the court said:

Decision. The proper administration of the fiscal affairs of the government, require that the payment of taxes should not be delayed by disputes as to their legality, but that the taxes should first be paid and all questions in regard to them be determined in suits brought for their refunding. It is a wise policy, therefore, that encourages the payment under protest of disputed taxes. Though there is some conflict in the dicta of the Supreme Court, we think that the true doctrine is that, when taxes are paid under protest that they are being illegally exacted, or with notice that the payor contends that they are illegal and intends to institute suit to compel their repayment, a sufficient foundation for such suit has been established.[57]

Actions to Restrain Payment of Taxes

If no claim for abatement is made, or if one is not permitted because a final decision has been made, or if claim is made and denied, the tax imposed must ordinarily be paid.

Suits to restrain collection of taxes—not maintainable.—

Law. Section 3224. [Rev. Stat.] [Barnes' Federal Code, Section 5123.] No suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court.

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[55] 192 U. S. 253, 48 L. Ed. 432, 24 Sup. Ct. 252 (1904).
[56] 159 Fed. 608, 86 C. C. A. 598.
[57] The mandate was recalled and amended in 163 Fed. 947, 90 C. C. A. 307, so as to include interest from the date of the judgment of the District Court.

The federal courts in construing this provision have uniformly held that no injunction will issue for this purpose.

It is of interest to note that, in the case of *Snyder v. Marks*,[58] although it was alleged that the "assessment was made more than fifteen months after the time which it embraced had elapsed," a bill in equity will not lie to enjoin a collector of internal revenue from collecting the tax. The following language of the court is of particular importance because it relates to section 3224, which is still in effect:

> Decision. The inhibition of section 3224 applies to all assessments of taxes, made under color of their offices, by internal revenue officers charged with general jurisdiction of the subject of assessing taxes against tobacco manufacturers. The remedy of a suit to recover back the tax after it is paid, is provided by statute, and a suit to restrain its collection is forbidden. The remedy so given is exclusive, and no other remedy can be substituted for it. Such has been the current of decisions in the Circuit Courts of the United States, and we are satisfied it is a correct view of the law.

It would appear that if Congress says in one section of the law that *no assessment* shall be made after the expiration of a certain period, and says in another that *no suit* shall be brought against the government to restrain the payment of taxes, the two sections should be construed together. If an injunction cannot be secured in case the assessment is made after the limitation period, the intention of Congress cannot be carried out. Otherwise the section in regard to the 3 or 5 years' limitation might as well have been omitted. Certainly, the enactments of Congress should have some effect. This principle is supported by the recent decision of the federal district court of Delaware in the case of *du Pont v. Graham.* This case is discussed in detail elsewhere.[59]

The case of *Markle v. Kirkendall*,[60] confirms the principle of the *Snyder* case. In the *Markle* case an attempt was made to restrain the collector from collecting a tax which

[58] 109 U. S. 189, 27 L. Ed. 901, 3 Sup. Ct. 157; decided November 12, 1883.
[59] See page 228.
[60] 267 Fed. 498.

the Commissioner had assessed against a taxpayer as a corporation, whereas the taxpayer was a copartnership when the tax was assessed. The court held that as long as the taxpayer can be brought within the terms of the law as taxable, the collector may not be enjoined, although his proceeding is erroneous or irregular. The tax must be paid and if an appeal for refund is disallowed a suit may then be brought against the collector for recovery of the tax paid.

In the case of *Dodge Bros. v. Osborn*,[61] Chief Justice White intimated that an injunction might be secured in exceptional cases.

Decision. . . . . the statute plainly forbids the enjoining of a tax unless by some extraordinary and entirely exceptional circumstance its provisions are not applicable.

The cases which hold that a stockholder may restrain collection in case of an *unconstitutional tax* were decided subsequent to 1883,[62] the date of the *Snyder* case.

It may very well be, therefore, in case it can be shown that a suit against a collector to recover the tax paid and interest would not afford the taxpayer an adequate remedy, because, in order to pay the tax he would be compelled to dispose of property at a figure below its real worth, for which, of course, the return of the tax and interest, would not reimburse him, that a court of equity, in the exercise of its inherent jurisdiction to afford relief where a suitor has no adequate remedy at law, would act by injunction to prevent the collection of a tax illegally assessed. Such an injunction was recently granted in Delaware.[63] Article 1050 states that the "restraining" provision does not apply to suits for injunctive relief.

The United States Supreme Court in a very recent case[64] has confirmed the general principle stated in the preceding paragraph. This decision, which was written by Chief Justice Taft, read in part as follows:

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[61] 240 U. S. 118, 36 Sup. Ct. 275, 60 L. Ed. 557.

[62] See page 259.

[63] *du Pont v. Graham.* See page 218.

[64] *Hill v. Wallace,* 66 L. Ed. 527 (Advance Opinions) decided May 15, 1922.

. . . . It has been held by this court, in *Dodge v. Brady,* 240 U. S. 122, 126, that Section 3224 of the Revised Statutes does not prevent an injunction in a case apparently within its terms in which some extraordinary and entirely exceptional circumstances make its provisions inapplicable. See also *Dodge v. Osborn,* 240 U. S. 118, 122. In the case before us, a sale of grain for future delivery without paying the tax will subject one to heavy criminal penalties. To pay the heavy tax on each of many daily transactions which occur in the ordinary business of a member of the exchange, and then sue to recover it back, would necessitate a multiplicity of suits and, indeed, would be impracticable. For the Board of Trade to refuse to apply for designation as a contract market, in order to test the validity of the act, would stop its 1600 members in a branch of their business most important to themselves and to the country. We think these exceptional and extraordinary circumstances with respect to the operation of this act make Section 3224 inapplicable. . . . .

Stockholders' suits.—In cases where a speedy determination of the constitutionality of the tax is desirable, a procedure has been followed which appears to be a justifiable evasion of the statutory inhibition against litigating the validity of taxes before their payment. This is done under the color of a stockholder's suit, brought to restrain the corporation from an alleged illegal use of the corporate assets. The right of a stockholder to maintain such a suit is now well established.[65] The application of this procedure to tax cases was first resorted to in the *Income Tax Cases,*[66] and has been subsequently upheld as proper in view of the confusion and injustice which would result if the corporation paid the tax.[67]

Collection of Taxes by Suit and Summary Process

It may be of interest to some taxpayers to include the articles of the regulations dealing with collection by suit and by summary process peculiar to United States practice.

[65] *Dodge v. Woolsey,* 18 How. 331, 59 U. S. 331, 1 Miller 284, 15 L. Ed. 401; *Hawes v. Oakland,* 104 U. S. 450, 14 Otto 450, 26 L. Ed. 827. (See equity rule 94.)

[66] *Pollock v. Farmers' Loan & Trust Co.,* 157 U. S. 429, 39 L. Ed. 759.

[67] *Brushaber v. Union Pacific Ry. Co.,* 240 U. S. 1, 36 Sup. Ct. 236, 60 L. Ed. 493; *Stanton v. Baltic Mining Co.,* 240 U. S. 103, 36 Sup. Ct. 278, 60 L. Ed. 546.

Collection by suit.—Obviously the government will not resort to an action at law if taxes can be collected by summary assessment followed by distraint on the property of the taxpayer. In the latter case the government "gets the money," in the former case a long period of time elapses before the action can be tried and in very many cases the government fails in its action. Therefore taxpayers who have meritorious cases cannot be criticized for not signing waivers which may enable the government to force the collection of taxes illegally assessed.

If the taxpayer agrees that the additional tax is due, the waivers should be signed, but not otherwise.[68] Specific, not blanket waivers, should be signed.

The law contains a limitation period both as to suits and assessments[69] for all laws.

Suits for taxes barred after five years.—

LAW. Section 1320. **That no suit or proceeding for the collection of any internal revenue tax shall be begun after the expiration of five years from the time such tax was due, except in the case of fraud with intent to evade tax, or willful attempt in any manner to defeat or evade tax. This section shall not apply to suits or proceedings for the collection of taxes under section 250 of this Act, nor to suits or proceedings begun at the time of the passage of this Act.**

The foregoing section applies to all internal revenue taxes. While included in the 1921 law, it also covers all prior laws.

Collection of tax by distraint.—The following regulation summarizes sections 3187 and 3196 of the Revised Statutes which authorize collectors to collect taxes by distraint and sale:

REGULATION. If any person liable to pay any taxes neglects or refuses to pay them within ten days after notice and demand, it shall be lawful for the collector or his deputy to collect such taxes with 5 per cent additional and interest at 12 per cent per annum by distraint

[68] For discussion of legality of waivers, see page 225.

[69] See page 218.

and sale of the goods, chattels or effects, including stocks, securities, and evidences of debt, or other property or rights of property, of the person delinquent. When goods, chattels, or effects sufficient to satisfy the taxes and penalties imposed upon any person are not found by the collector or deputy collector, he is authorized to collect such taxes by seizure and sale of real estate. . . . . . (Art. 1009.)

Rulings. The property of one spouse is not subject to distraint to enforce payment of an income tax obligation of the other spouse unless there has been a transfer of property from one spouse to the other after a tax has been assessed and demand made for payment thereof. (C. B. 5, page 239; O. D. 1056.)

Property possessed by a taxpayer at the time a lien for tax attached under section 3186, R. S., is subject to distraint for the collection of the tax and interest in the hands of a person who acquired it by reason of his death. (C. B. 5, page 239; O. D. 1144.)

In a recent case, a United States District Court decided that where the federal collector had levied warrant of distraint upon an insolvent corporation for unpaid taxes, the claim took priority over claims for taxes due a state, county or municipality.[70]

Enforcement of tax lien by bill in equity.—The government may secure a lien for unpaid taxes. The following regulation outlines the procedure which must be followed under section 3186 of the Revised Statutes:

Regulation. In the event of nonpayment of a tax and penalties after demand, the amount becomes a lien in favor of the United States from the time when the assessment list was received by the collector upon all property and rights to property belonging to the taxpayer, except that the lien is not valid as against any bona fide mortgagee, purchaser, or judgment creditor until notice thereof is filed in the proper public office or offices on Form 668. The collector may file such notice of lien upon making demand for payment of the tax, unless payment is made immediately upon demand. What is immediate payment will depend upon the nature of the demand. Where the collector contemplates filing such notice of lien on demand, whenever practicable, the demand should be made upon the taxpayer in person. In any case where there has been refusal or neglect to pay the tax and it has become necessary to seize and sell real estate to

[70] *U. S. v. San Juan County et al.*, 280 Fed. 120, January 19, 1922. (C. B. I-1, page 306; T. D. 3298.)

satisfy it, a bill in equity may be filed in a district court of the United States to enforce the lien of the United States for tax upon any real estate in which the delinquent has any right, title, or interest subject to the lien. This remedy does not supersede distraint but is cumulative. (Art. 1010.)

RULING. Section 3466, Revised Statutes, is in pari materia with sections 64 (a) and 64 (b) of the Bankruptcy Act, and to the extent that it is in conflict therewith it is superseded thereby. Therefore, no priority is given to Federal taxes except over creditors, and such taxes are not entitled to priority over the administration expenses of the bankruptcy proceedings. (C. B. 2, page 241; T. D. 3000.)[71]

It is assumed that the word "creditors" in the foregoing decision means unsecured creditors. Bankruptcy proceedings cannot operate to give the Government preference over prior lien creditors.

The district courts of the United States are invested with jurisdiction to render such judgments and decrees, both in law and in equity, as may be necessary or appropriate for the enforcement of the provisions of the law.[72]

Compromise of taxes and penalties.—Section 3229 of the Revised Statutes gives the Commissioner power to compromise cases of taxes and penalties both before and after suit has been commenced. The nature and extent of this power are explained in the following regulation.

REGULATION. The Commissioner, with the advice and consent of the Secretary of the Treasury, may compromise any civil or criminal case arising under the internal revenue laws instead of commencing suit thereon, and with the advice and consent of the Secretary and the recommendation of the Attorney General may compromise any such case after suit thereon has been commenced by the United States. Accordingly, the power to compromise extends to (*a*) civil and criminal cases; (*b*) cases whether before or after suit; and (*c*) taxes and penalties, except that taxes legally due from a solvent taxpayer may not be compromised. Refunds can not be made of accepted offers in compromise in cases where it is subsequently ascertained that no violation of law was involved. . . . . (Art. 1011.)

[71] This is a digest of the Circuit Court decision in the case of *Smietanka v. Zibell,* 263 Fed. 883.

[72] Section 1318.

A letter, similar in content to the following, suitably modified if the delinquent was a corporation, was used under the 1917 law by the collectors in charging taxpayers with delinquency and in notifying them of their privilege to submit offers in compromise.

Sir: Your return of net income was not received in this office until ......, thereby involving you in liability to a specific penalty of not less than $20.00, or more than $1,000, under the act of ......, in addition to the 50 per cent additional tax which will be assessed and collected.

The provisions of the act are mandatory, and no excuse or explanation can be accepted, except a showing that a complete or tentative return was in fact mailed in time to have reached this office, or a Deputy Collector, in the ordinary course of business on or before March 1, ...

However, before instituting proceedings in court for the imposition of the specific penalty, I am directed to call your attention to the provisions of section 3229, revised statutes, which reads in part as follows:

> "The Commissioner of Internal Revenue with the advice and consent of the Secretary of the Treasury, may compromise any civil or criminal case arising under the internal revenue laws instead of commencing suit thereon, ..."

Should you desire to take advantage of your privilege under this section and to submit an offer in compromise, the amount offered should be forwarded promptly *to this office* in the form of cash, postal money order, or certified check which can be cashed without cost, payable to my order, accompanied by an affidavit substantially in the following form:

> "To the Commissioner of Internal Revenue:
>
> "I hereby solemnly swear (or affirm) that my delinquency in filing return of net income as required by the act of ...... was not due to any intent to violate the law or evade taxation, but was due to (here insert, concisely and clearly, the reason for delay).
>
> "Desiring to compromise my liability I hereby tender the sum of $......, which I request be accepted in compromise of the specific penalty only."

To be signed and sworn to before a deputy collector, notary, or other officer authorized to administer oaths.

This affidavit will then be forwarded by me, together with the sum offered, to the Commissioner for consideration, and you will be

notified by him of his acceptance or rejection of your proposal. In the latter event, you may increase your offer, if you so desire.

In an opinion dated June 3, 1919,[73] the United States Attorney General held that claims falling in the following, among other classes may be compromised by the Commissioner whenever, in his judgment, such compromises are for the interest of the United States:

> Claims for sums of 5 per cent on amounts of income and excess-profit taxes not paid when due and interest at the rate of 1 per cent per month on said taxes, the collection of which is authorized by sections 9(a) and 14(a) of the act of September 8, 1916, and section 212 of the act of October 3, 1917.

The Treasury has also held in a law opinion[74] that an ad valorem fraud penalty "may at any stage be compromised by the Commissioner and the approving officials, whether or not it be formally assessed."

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[73] 31 Op. A. G. 459.
[74] C. B. 5, page 240; L. O. 1072.

CHAPTER XII

ABATEMENTS, CREDITS, AND REFUNDS

This chapter deals with the remedial procedure provided by the Treasury or the courts whereby the taxpayer may secure the abatement or cancellation of an assessment or obtain a refund of taxes overpaid.

Importance of filing claims.—The preceding chapter fully covers appeals from the findings of revenue agents, and in general all remedial measures up to the time of assessment. After an assessment has once been entered on the collector's list, there is no recourse except by a claim for abatement (before the tax is paid)[1] or refund (after the tax is paid).

Many of the additional assessments following examinations of taxpayers' returns are based upon erroneous conclusions drawn by examiners, which the courts would promptly reverse if the taxpayers brought suit. But suits at law are so expensive, or are thought to be, and delays and postponements are so frequent and annoying, that most of those against whom additional taxes are assessed pay even when they feel sure of the injustice of the tax.

Because of the many erroneous assessments which are made, taxpayers should be familiar with the details of steps to be taken to question an assessment. If a claim is refused, the necessary procedure to secure from the courts an impartial opinion as to the sufficiency of the taxpayer's side of the contention should be understood. Until the case reaches the courts it cannot always be said that the facts are passed

[1] Claims for abatement may now be filed in only a few instances. See page 269.

upon impartially.[2] The right of taxpayers to question the interpretations of the Treasury are discussed on page 198 *et seq.*

It is probable that many court decisions will be required before the rights of taxpayers are fully protected. In the meantime, all legal formalities in the nature of filing claims, making protests, etc., should be observed by taxpayers so that they may secure the benefit of any future decisions which reverse past rulings of the Treasury.

Taxpayer's right to question assessments.—Vast numbers of persons pay too much tax for a variety of reasons: ignorance; the desire to overpay rather than to underpay; the tendency to follow Treasury rulings even though obviously illegal; fear of penalties; fear that failure to pay will be called unpatriotic; and many others. In view of the fact that in a democracy the people are supposed to be sovereign and public officers their servants, this tendency is hard to understand. It probably results from the disinclination of the average well-to-do American to go to any trouble about overcharges of any kind. He will pay a cab driver an extortionate fare rather than question the rate. He will tip an insolent and inefficient waiter rather than be looked at unkindly or spoken to offensively.

It is so with taxes. But there should be a change. Public officers, at least those in Washington, are not to blame. An effort has been made to render the remedy of an aggrieved taxpayer as inexpensive and as little troublesome as possible. Taxpayers who refuse to acquaint themselves with the remedies and means for correcting erroneous assessments have only themselves to blame.

Abatement

The change of procedure brought about by section 250 (d) regarding notice and appeal in cases of proposed addi-

[2] For appeals to the Committee on Appeals and Reviews, see Chapter X.

tional assessments, has the effect of greatly restricting the use of the claim in abatement.[3]

This section (the pertinent clauses of which are quoted in full on page 218) after providing for the assessment of additional taxes only after notice and opportunity for appeal, states categorically that in all cases in which such assessments after notice have been made, "no claim in abatement of the amount so assessed shall be entertained: *Provided,* That in cases where the Commissioner believes that the collection of the amount due will be jeopardized by such delay he may make the assessment without giving such notice or awaiting the conclusion of such hearing. . . . ."

There can be no doubt as to the meaning of this language. Except in those cases where the Commissioner may believe the additional tax is in jeopardy, an application in the nature of a formal appeal must be allowed and a decision must be made before assessment, provided, of course, notice of appeal is filed in accordance with the statutory provision. If notice of appeal is not given within the specified time, or if the decision on appeal is unfavorable, the assessment will be made and must be paid in due course. The collector is not authorized to accept a claim for abatement. In such a case a claim for refund is the only recourse.

Abatements may be filed—when?—Claims for abatement have not, however, been entirely abolished. Use for such claims may be found in the following cases:

1. Where the Commissioner believes the tax is in jeopardy, in which case he may assess the tax without giving the usual notice and opportunity for appeal;
2. Where it is necessary to postpone payment of one or several instalments, as in cases where an error has

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[3] **[Former Procedure]** Under the previous laws the practice of filing claims in abatement had reached the proportions of a serious evil. With no satisfactory arrangements for insuring full hearings before additional assessments were imposed, the taxpayer's usual course upon receiving an assessment notice was to file such a claim.

been discovered before all instalments of a tax have been paid;

3. Where a claim for abatement or credit on file with the Treasury has been disallowed without the taxpayer having had an opportunity to be heard on appeal, a contingency which can be eliminated by changing the procedure with regard to claims of all kinds, a change discussed on page 239; and
4. Where an erroneous assessment is made, as when, through a mistake, assessments are made without legal notice to the taxpayer or in spite of a notice of appeal.

Experience will no doubt show that other cases will arise, because a claim for abatement may be used where there is any good reason to hold a payment in abeyance; provided, however, that the case is of a kind in which section 250 (d) does not specifically forbid its acceptance.

May abatement be allowed if an equivalent amount of tax is due?—Since abatement claims may be filed in so few cases under the 1921 law, the following ruling applies principally to cases arising under the 1918 and prior laws.

Ruling. The validity of an assessment depends upon the law and actual facts existing. Therefore, an assessment made upon an erroneous theory or by mistake may not be remitted or abated because so made if, at the time its validity is passed upon the Commissioner is in possession of evidence which shows an equivalent amount of tax is properly due in connection with the income, transaction or matter upon which the assessment is predicated. (C. B. 5, page 245; T. D. 3251.)

The validity of the foregoing ruling is questionable. Under the laws prior to 1921, interest did not begin to run until after assessment was made. This ruling may subject taxpayers to interest charges from the dates of the illegal assessment, without proper compliance by the Treasury with the sections of the law dealing with other assessments (even though meritorious) barred by limitation of time, as well as where interest

is specifically held to commence when collectors give notice of assessments.

Content of claim in abatement must be supported by sworn statement.—The following regulation sets forth the details of procedure in claims for abatements.

REGULATION. Claims for abatement of taxes illegally or erroneously assessed shall be made on Form 843. They must be sustained by the affidavits of the parties against whom the taxes were assessed or of other parties cognizant of the facts. When a tax has been assessed and turned over to the collector, the presumption is that the assessment is correct. The burden of proof in rebutting the presumption and showing that it was improperly or illegally assessed, or that relief should be given under a remedial statute, rests upon the applicant for abatement. The affidavits must therefore contain full and explicit statements of all the material facts relating to the claim in support of which they are offered and to the proper consideration of which they are essential. The legality of the claim is to be determined by the Commissioner upon the facts presented to him. The filing of a claim for abatement does not necessarily operate as a suspension of the collection of the tax or make it any less the duty of the collector to exercise due diligence to prevent the collection of the tax being jeopardized. He should, if he considers it necessary, collect the tax and leave the taxpayer to his remedy by a claim for refund. Claims for abatement may not be filed where the taxpayer has had the benefit of the provisions of section 250 (d).[4] . . . . (Art. 1032.)

The author's experience has been that many claims for abatement are denied because the foregoing reasonable and legal procedure is not followed by taxpayers. It is not enough to make a short affidavit to the effect that the tax is illegally or wrongfully assessed. It should be remembered that the additional assessment is often the result of a long and careful audit of the returns. The taxpayer is entitled to and should have full particulars of the basis of the assessment.

The claim for abatement should contain complete references to the law and regulations bearing on the matters in dispute and should cite such authorities, precedents and business prac-

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[4] Section 250 (d) gives the taxpayer the right, upon notice of assessment to be made in thirty days, to appeal before such assessment is finally made.

tices as are applicable. The author has never known of a case where the presentation of a properly prepared claim has not received careful attention.

Meaning of term "bona fide claim."—Section 250 (e) of the law, quoted on page 274, provides that, when the claim for abatement is made in good faith and subsequently denied, interest at the rate of ½ of 1 per centum per month, instead of 1 per cent, shall be charged on the tax from the time it was due until the claim is decided. It is therefore of great importance not to invoke the law unless the abatement can be proved to be "the subject of a bona fide claim." It has been shown that taxpayers have an undoubted right to question assessments, but the questioning of an assessment must be founded on more than mere doubt in order to support a contention that a claim for abatement is filed in good faith.

When the taxpayer is confident that his original return was properly prepared there can be little doubt as to the imposition of the 6 per cent interest rate if the claim for abatement is denied. The Commissioner, in order to impose the 12 per cent interest rate, would have to hold that the claim was made in bad faith. Taxpayers should be able to make a good showing in the hearing of their cases and leave no doubt in the minds of the reviewing authorities as to the good faith involved in the claim.

Collector may require a bond.—As it is within the discretion of a collector to accept or reject a claim for abatement and, as he is charged personally with the assessment, he may require a bond at the time of accepting a claim for abatement.

Ruling. . . . . While there is no provision of law expressly authorizing the collector to require a bond as a condition of suspending the collection of the tax, he is personally charged with the amount of the assessments made against taxpayers in his district and he is required to use due diligence in collecting such taxes. If he fails to exercise due diligence, it is clear that he becomes personally liable for any tax which may be lost through such failure. He may require the

tax to be paid and leave the taxpayer to his remedy by a claim for refund, and if he see fit to suspend the collection of the tax in any case where a final collection may thus be jeopardized he does it at his own risk. It is within his discretion to protect himself by requiring the taxpayer to execute a bond in the amount of the tax the collection of which is postponed. . . . . (C. B. 1, page 257; O. 957.)

Section 1329 provides that the collector may accept as security Liberty bonds or other bonds or notes of the United States.

Rejection of claim for abatement by collector.—After a claim for abatement has been accepted by a collector and has been forwarded to the Commissioner, collectors frequently send out a second notice and demand, although the Commissioner has neither allowed nor rejected the claim.

After a collector accepts a claim for abatement and forwards it to the Commissioner for consideration, in all fairness he should not send out a second notice and demand until the Commissioner has notified him that it has been rejected. At the time when the claim is accepted the collector must be convinced that it is a "bona fide claim," and that the taxpayer is in a position to pay and will pay the tax if the Commissioner, after consideration, rejects it. Of course, if after a claim has been accepted some unforeseen event takes place which may jeopardize the government's interest, it would be reasonable to demand either a bond or payment. But this certainly should be done only with the approval of the Commissioner, because there are many taxpayers who have claims pending with the Treasury which have been on file many months.

It is improper to include the 5 per cent penalty and interest at the rate of 1 per cent a month, because the penalty has been made inoperative by the filing of the claim for abatement, and interest can be collected only on the amount of the claim disallowed by the Commissioner.

When a second notice and demand is received, the matter should be taken up immediately with the collector. He should be informed that a claim for abatement is on file and that

it has not been acted upon by the Commissioner. By this means, it is probable that summary action by the collector will be prevented.

Claim for abatement filed by receivers—no bond required.—

RULING. Where the property of a corporation is in the hands of a receiver who files a claim for abatement of an additional assessment of income and profits taxes for 1917, no bond should be required as security for the payment of such taxes. The government, however, has the right under section 3466, R. S., to receive payment of these taxes from the receiver in preference to the creditors of the corporation. (C. B. 3, page 308; O. D. 733.)

Interest and penalties payable on rejected claims for abatement.—When claim for abatement is filed there is no assurance that it will be allowed by the Commissioner. Therefore, it is important that the claim be filed with the collector within ten days from date of assessment in order to prevent the 5 per cent penalty from being imposed.

LAW. Section 250. . . . . (e) . . . . *Provided,* That as to any such amount which is the subject of a bona fide claim for abatement filed within ten days after notice and demand by the collector, where the taxpayer has not had the benefit of the provisions of subdivision (d), such sum of 5 per centum shall not be added and the interest from the time the amount was due until the claim is decided shall be at the rate of one-half of 1 per centum per month on that part of the claim rejected. . . . . [5]

RULING. . . . . In accordance with the provisions of section 250 (e) and 250 (h) of the Revenue Act of 1921, interest at the rate of 1 per cent a month upon the rejected amount embraced in said claim for abatement for 1917 taxes, which claim was filed prior to the passage of the Revenue Act of 1921, ceased to run with the passage of that Act, and from that date until the claim for abatement was decided such rejected portion of the claim carries interest at the rate of one-half of 1 per cent a month. . . . . (I-31-443; I. T. 1408.)

The above ruling specifically provided that the abatement carried "interest at the rate of 1 per cent up to and including

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[5] [Former Procedure] Under the 1917 law claims for abatement carried interest at the rate of 1 per cent per month. The 1918 law reduced the rate to ½ of 1 per cent per month.

November 22, 1921, and interest at the rate of one-half of 1 per cent a month from November 23, 1921, until the claim was decided."

This ruling is questionable in two respects. Section 263 states "that this title [Title II of which section 250 is a part] shall take effect as of January 1, 1921." Therefore, if the 1921 law reduces the interest on claims in abatement to ½ of 1 per cent a month the reduction takes place when the 1921 law became effective, viz., January 1, 1921.

The author is of the opinion, however, that the law applies to all claims in abatement not rejected when the 1921 law was passed, including all open claims arising under the 1917 law. Section 250 (e) refers to "any tax", which of course includes 1917 taxes and provides "that as to any such amount which is the subject of a bona fide claim for abatement . . . . the interest from the time the amount *was due* until the claim is decided shall be at the rate of one-half of 1 per centum per month on that part of the claim rejected."

It is significant to note that section 250 (e) says interest shall be computed at the rate of ½ of 1 per cent *"from the time the amount was due* until the claim is decided."

Section 250 (h) provides:

> The provisions of subdivision (e) . . . . of this section shall apply to the assessment and collection of taxes which have accrued or may accrue under the Revenue Act of 1917, the Revenue Act of 1918 or this Act.

There is no statement in either of the foregoing sections which supports the decision of I. T. 1408, whereby interest on 1917 claims should be computed at the rate of 1 per cent per month up to and including November 22, 1921. Section 250 (h) specifically provides that all of subdivision (e) of section 250 "shall apply to the assessment and collection of taxes which *have accrued* or may accrue *under the Revenue Act of 1917."* Neither section 250 (e) nor 250 (h) states that beginning with November 23, 1921, interest on claims shall be computed at the rate of ½ of 1 per cent per month.

On the contrary, section 250 (e) says that the interest shall be computed *"from the time the amount was due,"* which is the date of filing of the claim.

It is true that section 13 of the Revised Statutes provides:

> The repeal of any statute shall not have the effect to release or extinguish any penalty, forfeiture, or liability incurred under such statute, unless the repealing Act shall so expressly provide, and such statute shall be treated as still remaining in force for the purpose of establishing any proper action or prosecution for the enforcement of such penalty, forfeiture, or liability.

But it would appear that the interest liability incurred under the 1917 law was expressly released or extinguished by provision of section 250 (h), which provides that "subdivision (e) . . . . shall apply to the assessment and collection of taxes which *have accrued* . . . . under the Revenue Act of 1917." In such case section 13 of the Revised Statutes has no application, as the interest penalty is specifically provided for.

The statements in sections 1400 (b) of both the 1918 and 1921 laws, which provide that the assessment and collection provisions of the 1917 law shall remain in effect for the collection of 1917 taxes, do not apply with respect to interest, as section 250 (e) specifically provides the manner of computing interest on all claims, and section 250 (h) provides that "subdivision (e) . . . . shall apply to the assessment and collection of taxes which *have accrued* or may accrue *under the Revenue Act of 1917.*"

It might be stated that the provisions of the 1917 law relating to assessment and collection were repealed as of January 1, 1921, or November 23, 1921, whichever date is correct; but section 250 (e) says interest shall be computed at the rate of ½ of 1 per cent *"from the time the amount was due."* Section 250 (h) also says "subdivision (e) . . . . shall apply to the assessment and collection of taxes which *have accrued* or may accrue *under the Revenue Act of 1917.*"

In view of the doubt as to the validity of the Treasury's interpretation of the law, taxpayers should only pay the 1 per cent rate under protest.

Section 250 (e), quoted on page 274, except for the right of hearing and appeal before assessment, is the same as in the 1918 law. A contention was made that the 1918 law reduced the interest on abatements to ½ of 1 per cent per month.

Ruling. . . . . It appears that in February, 1920, additional income and excess profits taxes for 1917 were assessed against this taxpayer; that a claim for abatement of the amount of the assessment was filed, which claim, under date of January —, 1921, was allowed for $6x$ dollars and rejected for $16.7x$ dollars; and that upon demand and under protest the taxpayer paid to the collector an additional sum of $2x$ dollars, representing interest at the rate of 1 per cent per month on the amount of the claim rejected. The taxpayer has filed a claim for refund of x dollars, being the amount of the alleged excessive interest paid. . . . . (I-34-470; A. R. R. 1026.)

In deciding the foregoing case the Committee adopted an opinion of the Solicitor who held that under section 1400 (b) of the 1918 law those provisions of the 1917 law which related to assessment and collection should remain in effect. The Solicitor also referred to section 13 of the Revised Statutes (quoted on page 276).

It is possible that the Solicitor is right as to all abatements claimed before January 1, 1918 (the effective date of the 1918 law). In any event the Solicitor should have ruled that the lower rate became effective on January 1, 1921, instead of November 23, 1921. Section 263 provides that section 250 "shall take effect as of January 1, 1921."

The author is of the opinion that the refund should have been allowed in full, as the abatement was not rejected until January, 1921, which was after the 1921 law became effective. (See discussion of I. T. 1408, page 274 *et seq.*).

Claims for inventory losses.—The 1918 law fixed the interest rate on such rejected claims at 1 per cent a month [section 214 (a-12)]. Ruling I-46-595; I. T. 1500 holds that the 1 per cent rate is still in force. If section 250 (e) is applicable, the ruling may not be sound. Payment should be made under protest until the point is authoritatively settled.

Credits

Prior to 1918, taxes overpaid in previous years could not be used to offset the taxes of later years. To remedy this injustice, Congress established the claim for credit.

When may a claim for credit be filed?—

LAW. Section 252. That if, upon examination of any return of income made pursuant to this Act, the Act of August 5, 1909, entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," the Act of October 3, 1913, entitled "An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes," the Revenue Act of 1916, as amended, the Revenue Act of 1917, or the Revenue Act of 1918, it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of section 3228 of the Revised Statutes, the amount of the excess shall be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from the taxpayer under any other return, ...

REGULATION. Any amount of income, war profits or excess profits tax paid in excess of that properly due shall be credited against any such taxes due from the taxpayer under any other return. To obtain such credit the taxpayer should proceed as follows:

(1) Where the credit demanded is equal to or less than any outstanding assessment of tax, a taxpayer desiring to obtain such credit shall file with the collector for the district in which his original return was filed a claim on Form 843, which shall be sworn to and shall contain the following statements: (*a*) business engaged in by the claimant; (*b*) character of assessment or tax; (*c*) amount of tax claimed as a credit; (*d*) unpaid assessment against which credit is asked and for what taxable year; and (*e*) all facts regarding the overpayment.

(2) Where the amount claimed as a credit is greater than the outstanding assessment of tax, a taxpayer desiring to obtain such credit and the refund to which he is entitled shall file Form 843, stating thereon the respective amounts claimed as a credit or as a refund. . . . . All the facts regarding the total overpayment should be stated in the claim. (Art. 1034.)

Claim for credit may be applied only against over-payment of "Income, War Profits, or Excess Profits Tax."—

RULINGS. Munitions tax overpayments for one year may not be credited against an additional assessment of munitions taxes for a subsequent or prior year.

Munitions tax overpayments may not be credited against additional assessments of income, excess profits and war profits taxes for the same or for any subsequent or prior taxable year. (C. B. 4, page 330; Digest A. R. M. 123.)

The tax imposed on undistributed net income of corporations by section 10 (b) of the act of September 8, 1916, as amended by the act of October 3, 1917, is held to be an income tax within the meaning of section 252 of the Revenue Act of 1918 and may, therefore, be credited against an additional amount of income tax due from the taxpayer within the limitations of that section. (C. B. 2, page 244; Digest O. 974.)

The amount of any ad valorem penalty and interest which has been collected without authority may be made the subject of a claim for credit against income, excess-profits, or war-profits taxes due from the taxpayer under any other return, if such claim is filed within the five-year period of limitation provided in section 252 of the Revenue Acts of 1918 and 1921.

This conclusion is based on the theory that interest and penalties are in the nature of accretions to the tax and should be considered as a part thereof in connection with any refund or credit of the tax. (I-37-505; I. T. 1447.)

Claim for credit may not include judgment claims.—

RULING. . . . . After careful reconsideration of the question it is the opinion of this office that section 252 of the Revenue Act of 1921 is not applicable to judgments and that no part of a judgment entered in favor of a taxpayer and against the United States or a collector for income and excess-profits taxes illegally or erroneously collected and interest allowed thereon by the court may be credited against any income or profits taxes then due from the taxpayer under any other return. . . . . (I-39-521; L. O. 1106.)

The author is of the opinion that the foregoing is contrary to the intention of Congress, and the spirit of section 252.

Collector need not receive clearance before accepting claim for credit.—It is no longer necessary for taxpayers to secure clearances for claims for credit.[6]

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[6] **[Former Procedure]** Taxpayers, however, who had claims for refund on file with the Department, and converted these claims into claims for credit in accordance with the regulations in effect prior to the issuance of Treasury Decision 3154 (April 12, 1921), should request the Commissioner to reject such refund claims and consider only their claims for credit. (Letter to Klein, Hinds and Finke, New York, N. Y., signed by Acting Commissioner M. T. West, and dated May 9, 1921.)

Regulation. Upon receipt by the collector of a claim for credit on Form 843, he will make proper record thereof in his office and, except in the case of claims covering tax assessed on the basis of returns on Form 1040 A, forward the claim immediately to the Commissioner irrespective of whether or not a claim for refund of the tax now claimed as a credit has previously been filed. Due notice will be given the collector and the taxpayer of the action taken on the claim.

If a claim is allowed against additional taxes due for other years, but such other taxes have not yet been assessed, only the amount of the excess of such taxes over the overpayment shall be assessed, or the excess of the overpayment over such taxes due shall be refunded as the case may be. The effective date of the filing of a claim for credit shall be the actual date of presentation to the collector. The filing of a claim for credit against the tax due under another return shall be subject to the same rules with respect to the addition of interest and penalties as if the taxpayer had filed a claim for abatement of the tax against which credit is desired. . . . .

Under no circumstances will a taxpayer be entitled to credit for an alleged overpayment of tax prior to the allowance of such credit by the Commissioner. An attempt to take a credit prior to such allowance shall not be held to be the filing of a claim under section 252 of the Revenue Act of 1921. (Art. 1035.)

What constitutes the making or allowance of a credit?—

Ruling. The reference, in effect, asks advice whether in a case where a claim for credit has not been filed by the taxpayer a credit for an excess of tax assessed for a prior year may be made or allowed if the examination of the return was made and the excess amount determined upon within the five-year period of limitation named in section 252, and the taxpayer within the limitation period was advised of the amount due on subsequent returns after the credit had been applied; but after the limitation period has expired the Department reconsiders and finds that a mistake was made in the amount of the tax due on the subsequent returns and the excess amount originally found as a credit (*a*) has not been changed, (*b*) should be increased, (*c*) should be decreased. It is assumed from the reference that the assessment represented by the original letter of advice to the taxpayer was not made. If it was made there would seem no room for doubt, since clearly the credit was made when the assessment list went out and any reduction or increase of tax would have to be accomplished by abatement or refund or further assessment.

The question presented depends for solution upon what constitutes the making or allowance of a credit within the meaning of

section 252. A statement contained in a letter from the Department to a taxpayer that the taxpayer is entitled to a credit is clearly not a credit actually made or allowed. Something must be done in a formal way that will amount to a direction to the collector who is charged with the collection of internal taxes. Prior to such a direction he has nothing to do with the taxpayer's account since it has not assumed that status of an account stated to him. Such direction by the Commissioner is usually made by formal assessment list signed by him. When such a formal statement or direction to the collector is signed by the Commissioner and forwarded to the collector, showing the amount of the tax to be collected over and above the credit, the Commissioner has formally made or allowed the credit. When this is done the credit has been made or allowed, but prior thereto anything that is done in the way of stating the case by employees of the Bureau or in the way of statements to the taxpayer in letters from the Department can be nothing more than preliminary to the actual making or allowance of the credit by the Commissioner.

This is true where credits are considered and passed upon formally by the Commissioner. Where, however, the collector because of the provisions of the statute and regulations made pursuant thereto makes the credit without specific instructions from the Commissioner, the credit is actually made or allowed when the collector so records it, and in such a case subsequent action by the Commissioner in the way of a review of the collector's action, would not operate to fix the time when the credit was made or allowed, since in such a case the collector had before him the account of the taxpayer and is charged by law and the regulations to enter the credit.

. . . . It is held that where the allowance of a credit as provided in section 252 of the Revenue Act of 1918 is being considered by the Commissioner, the credit is made or allowed only when the Commissioner signs and forwards to the collector a formal statement or direction or assessment list showing the amount of the tax to be collected over and above the amount of the credit. (C. B. 4, page 339; Sol. Op. 106.)

It is important that the privilege of filing claims for credit should not be abused, and the Treasury is justified in interpreting the law strictly. It is not unreasonable to require full compliance with the provisions regarding claims for refund.

It should be noted, however, that the Solicitor did not answer the question: "Did the taxpayer as a matter of fact make what might reasonably be deemed to be a claim for refund within the limitation period?"

Effect of a claim for credit.—

RULING. A . . . . credit can not be made until the facts have been carefully examined and the validity of the credit approved by the Commissioner. That is not to say, however, that a claim for credit has no effect until approved. The *claim* for credit may have precisely the same effect as a *claim* for abatement; that is, by forbearance of the collector it may suspend collection until it is acted upon by the Commissioner. If approved, credit is then given relieving both the collector and the taxpayer from any further liability. If rejected, interest is to be paid upon the amount suspended from the time it was due.

This view of the law appears to be entirely consistent with its language and also with the purpose which it was believed Congress had in mind; that is to say, relief to the taxpayer from being required to pay into the Treasury amounts, possibly large, at the same time that he is making a bona fide claim that other amounts are due him. As held in Law Opinion No. 957, it does not prevent the collector, if he so desires, from proceeding to collect at once just as he may do in the case of an abatement claim filed, but leaves it optional with him to suspend collection until such time as credit is given relieving both him and the taxpayer. (C. B. 2, page 247; A. R. M. 46.)

Law Opinion 957[7] took the position that in order to credit an amount of tax against an overpayment for previous years, such overpayment must have been actually ascertained. The above ruling is in accord with the law and is observed in present procedure.

Place of filing claim for credit when district is changed.—

RULING. Where a corporation filed a return for 1918 with the collector of one district and a return for 1919 with the collector of another district, and subsequently rendered an amended return for 1918, showing less tax liability, together with a claim for credit against the outstanding tax due for 1919, covering the overpayment to the extent shown by the amended return, it should file the amended return with the collector with whom the original return was filed for the year 1918.

The claim for credit should be filed with the collector with whom the return for 1919 was filed, who should forward same to the collector with whom the return for 1918 was filed, for a notation thereon of the facts required by the certificate on the reverse side as to the assessment overpaid for 1918. When this has been done it will be

[7] C. B. 1, page 256.

returned by him to the collector with whom the 1919 return was filed, who will make a notation thereon as to the 1919 assessment to be credited, and forward same to the Commissioner of Internal Revenue for consideration.

In filing the amended return the taxpayer should call attention to the fact that a claim for credit of the overpayment has been filed with the collector with whom the 1919 return was filed, and the collector with whom the claim for credit was filed should be notified that an amended return has been filed. (C. B. 3, page 310; O. D. 740.)

Claim for credit in case of affiliated companies.—

Ruling. Upon the audit of the returns of several affiliated companies for the period 1909-1917, inclusive, it is found that certain of these companies are entitled to refund on account of excess taxes paid during that period. On the basis of the consolidated return for 1918, covering these companies, it appears that assessment of additional taxes will be required. The question therefore arises whether refunds due the subsidiary companies may not be used as a credit against the additional tax to be assessed on the basis of the consolidated return.

For the purposes of the income tax Acts each affiliated corporation is considered a separate and distinct entity even though a consolidated return is submitted on behalf of all. A claim for credit or refund of excess tax paid by one of the affiliated corporations can be made only by the corporation entitled to receive such credit or refund. Thus with respect to refunds, credits, and additional assessments each affiliated corporation occupies a status similar to that of an independent and unaffiliated corporation. The additional tax assessed for the year 1918, on the basis of the consolidated return for that year, must be apportioned among the affiliated corporations, and to the extent that each debtor corporation is entitled to receive back a part of the taxes paid in prior years, a claim for credit may be filed and the amount of additional tax each subsidiary is required to pay may be reduced thereby by the amount it is entitled to receive. In case the amount payable to the subsidiary exceeds its proportionate part of the additional tax assessed under the consolidated return, it may file a claim for refund for the difference. A subsidiary which is required to pay additional tax and is at the same time entitled to receive back in the form of a refund a portion of the amount paid as taxes in prior years, may, however, within its option pay the entire amount of the additional tax and file a claim for refund for the entire amount it is entitled to receive. (C. B. 3, page 311; O. D. 683.)

Affiliated companies may apportion any tax assessed against them on any basis upon which they may agree; there-

fore apportionment should be made so as to exhaust the entire amounts due from the government for prior years.[8]

Partners may claim credit individually for overpayment made by partnership under the 1917 law.—

RULING. In accordance with a memorandum from the Solicitor of Internal Revenue, dated May 5, 1922, an overpayment of excess-profits taxes by a partnership for the year 1917 may be credited against any income taxes due from the individual members of the partnership, provided the claim for credit is accompanied by an agreement between the partnership and the individual members thereof requesting that such action be taken. This is in harmony with the converse of this ruling, which appears as A. R. R. 859 (Bulletin I-15-217), in which it was held that an overpayment of income taxes by the individual members of a partnership for 1917 may be credited against an additional assessment of excess-profits tax due from the partnership for that year. This decision also agrees with the ruling that overpayments of tax by a husband are allowable as a credit against amounts due from the wife as a result of the community property ruling. Credit for taxes in the above cases can not be made in the absence of express agreements between the parties concerned.

It is not necessary that the taxpayer file a formal claim for credit. Credits may be made between the accounts of individuals and partnerships of which the individuals are members and vice versa as well as between husband and wife, even though no claim for credit is actually involved, provided an agreement between the partners is obtained. Certificates of overassessment in such cases may, therefore, be made in accordance with the agreements without the taxpayer going through the formality of filing a claim for credit. (O. D. 180, C. B. 1, page 309, modified.)[9] (C. B. I-1, page 318; I. T. 1361.)

Claim for credit when a partnership was incorporated prior to July 1, 1919.—

RULING. Returns for 1918 were filed for a partnership and its members in accordance with the Revenue Act of 1917, prior to the passage of the Revenue Act of 1918, and tax paid accordingly. The partnership was incorporated prior to July 1, 1919, and elected to be taxed as a corporation under the provisions of paragraph 3, sec-

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[8] [Former Procedure] Under the 1917 law affiliated companies could apportion the excess profits tax, but the income tax was computed separately and paid by each company.

[9] O. D. 180 did not permit such a credit. For criticism of O. D. 180, see *Income Tax Procedure*, 1922, page 284.

tion 330, Revenue Act of 1918. Amended returns for 1918 showing overpayment of tax were filed by the partners.

There is no provision in the law whereby either the tax by the partnership or any excess tax paid by the partners may be credited against any tax liability of the successor corporation for any year. Remedy may be sought only by the partnership and the individual members thereof filing claims for the refunding of any excess tax paid. (C. B. 2, page 247; O. D. 457.)

In the opinion of the author, there is no reason why the above credit should not have been allowed, because the stockholders in the new corporation were the partners in the partnership. (See C. B. 3, page 310; O. D. 757.) The Treasury takes a very narrow view of this question as is shown by the following paragraph.

Sole owner of corporation may not claim credit for corporation's overpayments.—

Ruling. Certain corporations overpaid their taxes in prior years and there is no way in which they can now use the excess amount of tax paid as a credit inasmuch as there is no tax due. An individual owning 100 per cent of the stock in one of these corporations finds that he is liable to pay a tax to the Government and claims that he should not be required to pay his individual tax while the corporation of which he is the sole owner is waiting for a claim for refund to be adjusted and paid.

It is held that inasmuch as the individual and the corporation of which he is the sole owner are two separate and distinct entities, he is not entitled to claim as a credit against taxes due under his personal return an amount of tax overpaid by the corporation. (C. B. I-1, page 316; I. T. 1259.)

When successor corporation may file credit against overpayment of predecessor.—

Ruling. In view of the fact that the statute of New Jersey under which a merger or consolidation of corporations resulting in the formation of another corporation is accomplished provides, in effect, that the successor corporation shall represent predecessor corporations in the enforcement of their rights, it is held that the successor corporation is entitled to file claim for credit on account of the overpayment of tax by the predecessor corporation. (C. B. 4, page 335; O. D. 950.)

Claim for credit may be filed by either husband or wife.—

Ruling. Where claims for the refund of taxes erroneously paid for 1919 and prior years have been filed by the husband as a result of the Attorney General's ruling relative to community property under the laws of Texas (T. D. 3071), such claims for refund may be converted into claims for credit to be applied against any taxes due from the husband or wife as shown by separate returns filed by them for the taxable year 1920 and subsequent years, subject to the provisions of section 252 of the Revenue Act of 1918. Such claims for credit must be accompanied by an agreement signed by the husband and wife consenting to the adjustments therein demanded. A claim for refund may be filed for any excess of the amount claimed as a credit over taxes shown to be due. (C. B. 4, page 335; O. D. 854.)

See further, Chapter XVI.

Claim for credit arising from joint return.—

Ruling. When an amended joint return for 1918 is filed by husband and wife, a single claim for credit may be so applied against any outstanding taxes due at the time the claim for credit is filed, providing an agreement signed by the taxpayer and his wife consenting to the adjustments therein demanded accompanies such a claim. However, if no outstanding taxes are due by the taxpayer or his wife, a claim for refund of the excess taxes paid for 1918 should be filed, accompanied by the agreement by the taxpayer and his wife referred to. (C. B. I-1, page 316; Digest I. T. 1162.)

Refunds

After a tax has been paid and a taxpayer believes that it was unlawfully or wrongfully assessed or collected he may make claim for refund (on form 843). Generally speaking, excepting restriction with respect to time limit for filing, the government imposes no restrictions upon claims for refund and such claims are considered on their merits. This practice must not be confused with the procedure in case of *suit* against the government. When suit is brought the government interposes all the legal obstacles at its command.

Regulation. Claims by the taxpayer for the refunding of taxes and penalties erroneously or illegally collected shall be made on Form 843. In this case the burden of proof rests upon the claimant.

All the facts relied upon in support of the claim should be clearly set forth under oath. In the case of the taxpayer's death, certified copies of the letters of administration or letters testamentary, or other similar evidence, must be annexed to the claim to show the authority of the administrator or executor. The affidavit may be made by an agent of the person assessed, but in such a case a power of attorney must accompany the claim. Checks in payment of claims allowed will be drawn in the names of the persons entitled to the money and shall, unless otherwise directed, be sent directly to the proper persons. The Commissioner has no authority to refund on equitable grounds penalties legally collected.[10] . . . . (Art. 1036.)

It should be noted that the regulations do not require that claims for refund must be accompanied by the collector's receipt or by the paid cheque showing payment of the tax.

If claim for abatement was not made, the claim for refund should be supported by satisfactory evidence as described on page 271. If claim for abatement was made and denied it cannot be expected that the claim for refund will be allowed, but the taxpayer has nothing to lose by attempting to improve his case and by securing any new evidence which will strengthen it.

Claims for refund may not be filed with Commissioner directly.[11]—Notwithstanding that section 3228 of the Revised Statutes, as amended by section 1316, provides that claims for refund " must be presented to the Commissioner," the Treasury for administrative reasons requires claims to be filed with the collector.

RULING. Claims for refund should in all cases be filed with the collector of internal revenue to whom the tax was paid or with the deputy collector of the division of such district in which the claimant resides. Warrants in payment of such claims will be made to the order of the claimants as provided in section 6, Department Circular 230. (C. B. 4, page 408.)

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[10] For cases in which refund is made through collectors, see *Income Tax Procedure,* 1920, page 217.

[11] Formerly, claims for refunds could be filed directly with the Commissioner. See letter dated March 29, 1919, *Income Tax Procedure,* 1921, page 212.

Attorney may file claim for refund and receive warrant.—

RULINGS. The Bureau will recognize a general power of attorney as sufficient authority for the filing of more than one claim for refund on behalf of the grantor of such power. It should be noted, however, that under the provisions of section 6 of the above-mentioned circular special powers are required in certain cases. In cases where a number of claims are to be filed under a general power of attorney the original power should be attached to the first claim filed on behalf of the claimant granting the power, and a copy thereof should be annexed to each succeeding claim, special reference being made in each copy to the claims to which the original instrument was attached.

The Bureau does not require that a power of attorney to file a claim for refund be in any special form. It is merely necessary that the instrument meet the legal requirements of powers of attorney in general.

A power of attorney given by a corporation should be signed by the officers who are duly authorized to execute such instrument.[12] (C. B. 4, page 341; O. D. 927.)

Before a refund may be made of a tax paid by a withholding agent in behalf of a foreign Government, it is necessary that a power of attorney be obtained from the foreign Government authorizing the agent to file the claim and to collect the money in its behalf. In the absence of special authorization, the diplomatic representative of the foreign country may not act for the foreign country in matters of public moneys. (C. B. I-1, page 318; I. T. 1175.)

Formal claims for refund not necessary in some cases.— The Commissioner may issue warrants to cover overpayment without requiring the taxpayer to file a formal claim for refund or credit when the Treasury's examination shows an overpayment by the taxpayer. It is advisable, however, always to file a formal claim. If a claim has been filed, the Commissioner may make a refund even though the statutory period expires subsequent to the filing of the claim.

LAW. Section 1315. That section 3220 of the Revised Statutes, as amended, is reenacted without change, as follows:

"Section 3220. The Commissioner of Internal Revenue, subject to regulations prescribed by the Secretary of the Treasury, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, all penalties collected without authority, and all taxes

[12] For form of power of attorney, see page 191.

that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected; . .. . ."[13]

The Solicitor issued the following opinion interpreting the 1918 law. It is equally applicable to the 1921 law.

RULING. . . . . Section 3220, Revised Statutes, was amended by Congress at the instance of the Treasury Department. Before amendment section 3220, Revised Statutes, provided that the Commissioner could remit or refund taxes subject to regulations made by the Secretary only upon appeal to him made. The Treasury Department believed that a taxpayer should in every case be advised of every overpayment of tax and that the overpayment should be refunded, and it was believed that it would facilitate the work of the Internal Revenue Bureau if the Commissioner could make a refund without the necessity of a claim being filed. It was not the intention of the Treasury Department that the Commissioner should have authority to allow claims which were barred by any statute of limitation, or to refund a tax where the taxpayer had no right to file a claim for the refund therefor. It was apparently not the intention of Congress to make it possible for the Commissioner, subject to regulations made by the Secretary, to ignore statutes of limitation. It must therefore be held that the Commissioner has authority to refund a tax only in a case where a claim has been filed which is not barred by any statute of limitation or where the taxpayer has a legal right to file a claim for the refund of the tax. (C. B. 3, page 302; Sol. Op. 79.)

Collectors have been instructed that a reduction of assessments and adjustments of overpayments of revenues may be accomplished "on the basis of a certificate of overassessment prepared by the appropriate administrative unit in the Bureau in each case in which an overassessment of tax is disclosed through the audit of a return."[14]

Claims for refunds by resident or non-resident aliens.—

RULING. When a claim for refund is filed by aliens, resident or non-resident, on Form 46, a copy of the form upon which the alien was assessed and taxed should be attached to Form 46.[15] (C. B. 1, page 258; O. D. 472.)

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[13] Section 1323 (section 1316 of the 1918 law) re-enacts section 3225 of the Revised Statutes which limits refunds to cases in which the return was not *willfully* false.

[14] T. D. 3260, dated December 8, 1921.

[15] Form 46 has now been replaced by form 843.

Treasury can not apply refund or credit against taxes barred by statutory period.—

RULING. An amount refundable under section 252 of the Revenue Act of 1921 can not be applied against a tax which is not collectible, either by assessment or suit, due to the running of the statute of limitations. . . . . (C. B. I-1, page 313; L. O. 1095.)

Time limits for filing claims for refund.—Taxpayers, in order to secure credits or refunds of taxes overpaid, must file their claims before the expiration of five years from the dates when the returns were made or within four years after payment of tax.[16]

LAW. Section 252. That if, upon examination of any return of income made pursuant to this Act, the Act of August 5, 1909, entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," the Act of October 3, 1913, entitled "An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes," the Revenue Act of 1916, as amended, the Revenue Act of 1917, or the Revenue Act of 1918, it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of section 3228 of the Revised Statutes, the amount of the excess shall be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from the taxpayer under any other return, and any balance of such excess shall be immediately refunded to the taxpayer: *Provided,* That no such credit or refund shall be allowed or made after five years from the date when the return was due, unless before the expiration of such five years a claim therefor is filed by the taxpayer: *Provided further,*[17] That if upon examination of any return of income made pursuant to the Revenue Act of 1917, the Revenue Act of 1918, or this Act, the invested capital of a taxpayer is decreased by the Commissioner, and such decrease is due to the fact that the taxpayer failed to take adequate deductions in previous years, with the result that an amount of income tax in excess of that properly due was paid in any previous year or years, then, notwithstanding any other provision of law and regardless of the expiration of such five-year period, the amount of such excess shall, without the filing of any claim therefor, be credited or refunded as provided in this section: *And provided further,* That nothing in this section shall be construed to bar from allowance claims for refund filed prior to the

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[16] See page 291.

[17] [Former Procedure] The clause from this point forward first appeared in the 1921 law.

passage of the Revenue Act of 1918 under subdivision (a) of section 14 of the Revenue Act of 1916, or filed prior to the passage of this Act under section 252 of the Revenue Act of 1918.

LAW. Section 1316. [Section 3228, Rev. Stat.] "All claims for the refunding or crediting of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty alleged to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, must be presented to the Commissioner of Internal Revenue within four years next after payment of such tax, penalty, or sum."

This section, except as modified by section 252, shall apply retroactively to claims for refund under the Revenue Act of 1916, the Revenue Act of 1917, and the Revenue Act of 1918.[18]

Under section 252 the Treasury may grant refunds for all years subsequent to 1909 when based upon inadequate depreciation or other deductions to which the taxpayer was entitled in such years. These refunds must be made in connection with examination of returns made under the 1917, 1918 or 1921 laws.

Generally speaking, the distinction between section 252 and section 3228 (Revised Statutes) is that the former applies only to income, excess profits and war profits taxes; while the latter applies to all taxes specified—all Internal Revenue Acts. Furthermore, section 3228 grants relief in cases not covered by section 252. There is no doubt about the right to file claims for refund within five years after the return was due. Dr. Adams in explaining sections 250 and 252 to the (Finance) Committee stated, "We have placed on the Government a five-year limitation and on the taxpayer a five-year limitation." (C. B. I-1, page 314; L. O. 1095.) As to 1917 returns the five years expire April 1, 1923.

Sometime during 1919, the Solicitor expressed the opinion that section 252 of the Revenue Act of 1918 was not intended to take away the right given a taxpayer under section 3228 of the Revised Statutes to make a claim for refund within

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[18] [Former Procedure] Before amendment in 1921 this section provided that the claims must be presented "within two years next after the cause of action accrued."

two years after the cause of action accrued or the date of the payment of the tax under protest.[19] Presumably the same interpretation also applies to section 252 of the 1921 law. In other words, it supplements the present section 3228, with its limitation of "four years next after payment."

MEANING OF "PAID".—

RULING. . . . . Reference is made to a letter of April 7, 1921, wherein the following statement was made and questions asked:

The taxpayer's books and accounts are examined by a revenue agent. The agent finds that for the year 1914 the taxpayer has overpaid the amount of tax due. He also finds that the taxpayer owes additional tax for the year 1916, and in the adjustment of the agent's report the overpayment for 1914 is applied as a credit against the additional tax found due for 1916 and the balance of the 1914 overpayment is refunded. It later develops that the taxpayer instead of being liable for additional tax for the year 1916, as found by the revenue agent, has overpaid his tax for that year. The taxpayer files a claim for credit of this overpayment against tax due for subsequent years. The question presented is, how much tax may be assumed to have been paid by the taxpayer for the year 1916, i.e., the amount actually paid in cash or the cash payment plus the credit on account of the overpayment for 1914?

If it is held in the foregoing that the taxpayer has paid the cash payment plus the amount credited on account of the overpayment for 1914, and a claim for refund is filed, how should the refund claim be adjusted?

It is to be understood that in both instances mentioned above no record of a credit for overpayment of 1914 tax against additional tax originally found due for the year 1916 appears on the assessment list.

. . . . . The Government in the present instance was expressly authorized to refund the taxes erroneously collected or to accept such taxes as a credit. The credit having been duly made, it seems clear that if the real remedial purpose of section 252 is to be effected, "paid" must be construed in its broader sense as including a credit duly made. It is accordingly held that where there has been an overpayment of taxes on an income return for a certain year and within five years from the date the return was due the overpayment is credited to taxes due on an income return for a subsequent year, such credit constitutes payment or part payment of the taxes for the year in which it was applied.

In reply to your second question, you are advised that the cash payment plus the amount allowed as a credit on account of the over-

[19] C. B. 1, page 249; O. 833.

payment for 1914 should be adjusted for the year 1916 where the taxpayer files a claim for refund covering the latter year.

The fact that no record of a credit for overpayment of 1914 taxes appears on the 1916 assessment list does not affect the treatment of the credit as a payment for the year 1916, where the credit was in fact made within five years from the date the 1914 return was due. (C. B. 4, page 336; Sol. Op. 107.)

Closing date of five-year period.—

Ruling. . . . . the schedule authorizing the allowance of a claim for refund must be actually signed by the Commissioner within five years from the date when the return was due, taking into consideration any extension of time granted for filing the original return.

(b) Does the fact that a revenue agent's report, or a valuation engineer's report, determining an overpayment within the five-year period, is not audited until after the five-year limit, bar the auditor from allowing same as an offset, it being recognized that taxpayer is not in possession of the valuation engineer's finding and in some cases not in possession of the revenue agent's report, and, therefore, could not have filed claim within the five-year limitation?

A. Neither a refund nor a credit claim could be allowed under these circumstances. If a claim for refund is filed and the overpayment considered in connection with the refund claim, it would be barred by the five-year limitation. If it is proposed to allow credit for the overpayment, the fact that an overpayment has been made is not conclusively determined until audit of the agent's or engineer's report which is subsequent to the expiration of the five-year limitation.

(c) The auditor in auditing a case finds overpayment for 1913 and offsets this overpayment in an A-2 letter to taxpayer dated February 25, 1919. The taxpayer takes exception to depletion allowed and after several conferences with the valuation engineers a greater depletion for all years is allowed and a reaudit of his return is made October 10, 1919. The five-year limitation on 1913 has expired at the time the latter audit was made. Can this credit be allowed in view of the fact that a portion was allowed in the audit of February 25, 1919, or is the entire amount now barred by the statute?

A. The additional overpayment determined subsequent to the expiration of the five-year limitation could neither be refunded nor credited. . . . (C. B. 4, page 332, Mim. 2764.)

Claims filed before September 8, 1916.—

Ruling. . . . . It is therefore the opinion of this office that a claim for refund filed prior to the passage of the Revenue Act of 1916 and after five years from the due date of the return and rejected

either under section 3228, Revised Statutes, or on its merits can not be made the basis of a claim for refund under section 252 of the Revenue Act of 1921. A claim filed prior to September 8, 1916, may be allowed, however, under section 252 when filed within five years from the date the return was due, regardless of whether it was theretofore rejected under section 3228, Revised Statutes, or on its merits. .... (C. B. I-1, page 319; L. O. 1093.)

Claims filed under section 14 (a) of 1916 law.—It will be recalled that during 1920 a ruling appeared to the effect that claims filed under section 14 (a) of the 1916 law, but which were not filed within five years from the date when the return was due, could not be allowed under the 1918 law.[20] The last proviso in section 252 of the 1921 law (see page 291) revives these claims.

Ruling. .... The second query propounded raises the question whether a claim filed under section 14 (a) of the Revenue Act of 1916, which could not be allowed under section 252 of the Revenue Act of 1918 because not filed within five years of the due date of the return, may now be allowed by reason of the last proviso of section 252 of the Revenue Act of 1921. It will be noted from Solicitor's Opinion 79, heretofore quoted, that claims filed under section 14 (a) of the Revenue Act of 1916, pending in the Commissioner's office on February 25, 1919, and not saved by section 252 of the Revenue Act of 1918, fell by reason of the repealing Act. That opinion recognized the unfortunate situation which the above ruling resulted in and recommended congressional relief. ....

.... It was to meet this situation that Congress, in substantially re-enacting section 252 in the 1921 Act, added the last proviso thereof already set forth in this opinion.

Claims filed under section 14 (a) more than five years from the date when the return was due would have been refundable except for the prohibition found in section 252 of the Revenue Act of 1918. Section 14 (a) merely permitted the filing of the claim and, once filed, the authority for the refund was found in section 3220, Revised Statutes; section 252 of the 1918 Act having been repealed by the 1921 Act and the same section of the later Act having specifically provided that nothing contained therein shall be construed to bar from allowance claims for refund filed prior to the passage of the 1918 Act under subdivision (a) of section 14, supra, such overpayment may be refunded. The legislative history of the proviso clearly discloses

[20] C. B. 3, p. 302; Sol. Op. 79. For the author's comment on this ruling, see *Income Tax Procedure*, 1922, pages 214-215.

that its purpose was to permit of the allowance of claims filed under section 14 (a), regardless of whether such claims were filed within five years from the date the return was due, and this is further emphasized by the fact that it follows the general five-year limitation contained in section 252 and also that proviso which takes away every limitation as to time in the case of the recomputation of invested capital by the allowance of depreciation. It is believed that the proviso serves to grant the relief intended. To hold otherwise would make meaningless this provision of the Act.

It is therefore held that a claim for refund of taxes filed prior to the passage of the Revenue Act of 1918 under the provisions of section 14 (a) of the Revenue Act of 1916 may be allowed under the last proviso of section 252 of the Revenue Act of 1921. . . . .

(3) . . . . a written motion or application filed under section 14 (a) of the Revenue Act of 1916 to reopen a claim for refund theretofore rejected under section 3228, Revised Statutes, satisfies the requirement of section 14 (a), and if filed before the passage of the Revenue Act of 1918, the claim may be allowed under section 252 of the Revenue Act of 1921. (C. B. I-1, page 319; L. O. 1093.)

RESPONSIBILITY FOR REOPENING OLD CLAIMS.—

RULING. (4) A claim heretofore rejected and now allowable by the provisions of section 252 of the Revenue Act of 1921 should not be reopened and allowed by the Bureau on its own motion, except in those cases where, in the regular course of the examination of a return, it is found that a tax has been paid in excess of the amount due. (C. B. I-1, page 319; L. O. 1093.)

SOLDIERS' AND SAILORS' RELIEF ACT DOES NOT APPLY TO TIME LIMIT ON REFUNDS.—

RULING. Section 205 of the Soldiers' and Sailors' Relief Act (40 Stat. 440), which excluded the period of military service in computing the period limited by law for the "bringing of any action," has no application to claims for refund and credit under the provisions of section 252 of the Revenue Act of 1921. (C. B. I-1, page 311; Digest I. T. 1269.)

Suits for recovery must be started within five years after payment.—An appeal to the Commissioner in the form of a claim for refund is the first step in seeking relief by a taxpayer. If the Commissioner delays action on the claim for refund, suit may be brought against the collector after six months, without awaiting the Commissioner's decision.

Law. Section 1318. That section 3226 of the Revised Statutes is amended to read as follows:

"Section 3226. No suit or proceeding shall be maintained in any court for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Commissioner of Internal Revenue, according to the provisions of law in that regard, and the regulations of the Secretary of the Treasury established in pursuance thereof. No such suit or proceeding shall be begun before the expiration of six months from the date of filing such claim unless the Commissioner renders a decision thereon within that time, nor after the expiration of five years from the date of the payment of such tax, penalty, or sum."

This section shall not affect any suit or proceeding instituted prior to the passage of this Act, but shall apply to all suits and proceedings instituted after the passage of this Act, whether or not barred by prior Acts of Congress.[21]

For instance, if taxpayers file claims for refund four years, six months and one day after the day the tax was paid and the Commissioner does not render a decision within six months, suits cannot be instituted. No suit can be instituted "after the expiration of five years from the date of the payment of the tax."

Since the Treasury is experiencing difficulties in clearing up claims within the five-year limit, taxpayers should be careful not to permit the period to expire before instituting suit.[22]

Proof of appeal to Commissioner.—The Court of Claims of the United States has decided that when suit is brought by a taxpayer against the collector for recovery of the tax, the

[21] [Former Procedure] For details of procedure under former laws, see *Income Tax Procedure*, 1921, page 220.

[22] [Former Procedure] Under section 3227, Rev. Stat., repealed in 1921, it was possible to postpone suit for six years or more. See *Income Tax Procedure*, 1921, pages 219 and 220.

The government in the case of *Rockefeller v. United States of America* (42 Sup. Ct. 68, 66 L. Ed.—) asserted that the claim was barred two years and six months after the appeal to the Commissioner. The United States Supreme Court considered this case on its merits, hence this decision may be accepted as finally disposing of this point. This repeal does not, of course, affect any suit or proceeding as described in section 3227, instituted prior to the 1921 law.

burden of proof is upon him to show that his appeal to the Commissioner has been taken and decided, or else that decision was delayed more than six months from the date of appeal.[23]

Decision. The written appeal was the best evidence of which the case was susceptible, and if it was not in his power to have produced the original, it was nevertheless his duty to have produced an authentic copy thereof, or accounted for its absence.[24]

Regulation. The lodging of an appeal (claim for refund) made out in due form with the proper collector of internal revenue, for the purpose of transmission to the Commissioner of Internal Revenue in the usual course of business under the requirements of the regulations of the Secretary of the Treasury, is in legal effect a presentation of the appeal to the Commissioner. (Reg. 33, 1918, Art. 270.)[25]

An amended return or claim for abatement does not constitute an appeal.—The 1921 law amended section 3226, Revised Statutes, by inserting the specific statement that "no suit . . . . shall be maintained . . . . until a claim for refund or credit has been duly filed with the Commissioner. . . . ."[26]

Ruling. . . . . (d) A taxpayer, on April 15, 1918, filed amended returns for 1913 and subsequent years which showed an overpayment for 1913. The amended returns were not audited until July 1, 1919—four months after the expiration of the five-year limitation placed on the original return. Does the filing of an amended return within the five-year period act in the same capacity as a claim, as far as being allowed to offset the overpayment against an additional tax, or is it barred due to the fact that the final audit was not reached before the expiration of the five-year limitation on 1913 return?

A. . . . . Amended returns do not take the place of a claim for refund or credit, and if filed, unsupported by such claim or claims, do not in themselves constitute a sufficient claim within the meaning of the statute to warrant the crediting or refunding of any taxes thereunder after the expiration of the five-year period. (C. B. 4, page 332; Mim. 2764.)

The Supreme Court of the United States has held[27] under

[23] *Lauer v. U. S.*, 5 Ct. Cl. 447.
[24] *Hubbard v. Kelley*, 8 W. Va. 46.
[25] This regulation is based upon *U. S. v. Real Estate Savings Bank*, 14 Otto 728, 104 U. S. 728, 26 L. Ed. 908, 28 Int. Rev. Rec. 87.
[26] See page 296 for text of section 3226, Rev. Stat., as amended.
[27] *Rock Island, Arkansas & Louisiana Railroad Co. v. U. S.*, November 22, 1920, 254 U. S. 141, 65 L. Ed. 188, 41 Sup. Ct. 55.

an earlier law that a claim in abatement does not constitute an appeal to the Commissioner for a refund. For this decision as well as a decision[28] of a Circuit Court of Appeals taking the opposite position see *Income Tax Procedure,* 1922, pages 265-267. In view of this situation, taxpayers should be careful to reserve their legal rights by filing a claim for refund when a claim for abatement is rejected.

In a lower court, however, it has been held that if the Commissioner advised the taxpayer that no claim for refund was necessary, under such circumstances, the collector can not defend on the ground that claim for refund was not filed.[29]

Application for special relief does not constitute a claim for refund or credit.—

Ruling. An application for special assessment under the provisions of sections 327 and 328 of the Revenue Act of 1918 does not in itself constitute a sufficient specific protest to meet the requirements of section 1324 of the Revenue Act of 1921, relative to the payment of interest on claims for credit or refund allowed after the passage of such Act. (C. B. I-1; page 404; I. T. 1335.)

Suit must be brought against collector who collected tax and not against his successor.—The United States Circuit Court of Appeals for the Seventh Circuit certified the following two questions to the United States Supreme Court:[30]

Decision. 1. Assuming that the declaration states a good cause of action had the suit been brought against S. M. Fitch, the internal revenue collector who actually collected and received the taxes, does it state any cause of action whatever against said S. M. Fitch's successor in office, the plaintiff in error, against whom the suit was brought, but who had no participation in the collection, receipt, or disbursement of such taxes?

2. May suit in the district court of the United States properly be brought and maintained against a United States collector of internal revenue for the recovery of the amount of a United States internal revenue tax, unlawfully assessed and collected, but in the col-

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[28] *Loomis v. Wattles,* 266 Fed. 876. In the *Rock Island* case, supra, the Supreme Court criticized *Loomis v. Wattles.*

[29] *Black v. Bolen,* 268 Fed. 427.

[30] *Smietanka v. Indiana Steel Co.,* 42 Sup. Ct. 1, 66 L. Ed.—

lection and disbursement of which such collector had no agency, the entire transaction of such assessment, collection, and disbursement having occurred during the incumbency of such office of a predecessor in office of such collector?

The court answered both questions in the negative.[31]

Suits when collector is dead.—The 1921 law gives a district court concurrent jurisdiction with the Court of Claims in cases where the collector is dead.[32]

LAW. Section 1310. . . . . (c) Paragraph Twentieth of section 24 of the Judicial Code is amended by adding at the end thereof the following new paragraph:

"Concurrent with the Court of Claims, of any suit or proceeding, commenced after the passage of the Revenue Act of 1921, for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected, under the internal-revenue laws, even if the claim exceeds $10,000, if the collector of internal-revenue by whom such tax, penalty, or sum was collected is dead at the time such suit or proceeding is commenced."

State courts have no jurisdiction to determine federal taxes.—Two interesting cases,[33] decided by the Supreme Court of Errors for the State of Connecticut, hold that section 3449 of the Connecticut Statutes, which provides that any claim not presented to trustees in the liquidation of the affairs of a corporation within the time limited shall be barred, does not apply to federal taxes.

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[31] The District Court for the Southern District of Ohio, Western Division, has made a similar ruling. *Cincinnati Gas & Electric Co. v. Gilligan* (not reported). See C. B. 5, page 248; Ct. D. 16. See also *Philadelphia, Harrisburg & Pittsburg R. R. Co. v. Lederer,* 242 Fed. 492, 155 C. C. A. 268; and *Detroit Hotel Company v. James J. Brady,* Collector of Internal Revenue, First District of Michigan, 275 Fed. 995, quoted as C. B. I-1, page 402; T. D. 3314, March 31, 1922.

[32] [Former Procedure] Prior to the passage of the 1921 law, if the amount involved exceeded $10,000, suit could not be brought in a federal district court if the collector were dead, but the Court of Claims had sole jurisdiction.

[33] *Willmann, et al. v. Walsh,* 112 Atl. 804, 96 Conn. 79; and *Application of Willmann, et al.,* 112 Atl. 806. For the details of these decisions, see *Income Tax Procedure,* 1922, pages 268-271.

The higher court affirmed the lower court's decision in each case. In commenting upon the second case, the higher court said:[34]

DECISION. The facts found disclose that the federal taxes involved in these proceedings have not been paid, and that a claim for the abatement of said taxes is pending before the Commissioner of Internal Revenue, under Section 5949 (Sec. 3226, R. S., U. S.) of the Compilation of United States Statutes 1916. Under such facts, in accord with the terms of Section 5949 (Sec. 3226, R. S., U. S.) no suit, formal or, as here, informal, can be maintained to recover back or to abate such federal taxes in any court, state or federal.

Under Section 5947 of such Compilation no suit, formal or informal, can be maintained to restrain the collection of federal taxes.

Therefore the superior court had no jurisdiction to pass upon the legality of the assessment of the internal revenue taxes in question, or to issue a restraining order relating thereto, because of the provisions of the United States Statutes quoted above.

Amount recoverable by suit includes penalties improperly collected.—If an illegal tax is paid, the fact that it was not paid within the time allowed by law will not prevent any taxpayer from recovering the penalty of 1 per cent a month paid by him for non-payment; for if the tax was illegal it was never due and therefore the penalty was as much unauthorized as the tax itself.[35]

Interest allowable on refunds, whether granted by the Commissioner or the courts.—Contrary to all previous laws, the 1921 law provides that interest must be paid upon all claims for refund or credit allowed. The section seems to apply to refunds arising under all previous laws and covers all internal revenue taxes. Interest when allowed is payable on all claims, whether allowed by the Commissioner voluntarily or by the courts.

LAW. Section 1324. **(a) That upon the allowance of a claim for the refund of or credit for internal revenue taxes paid, interest shall be allowed and paid upon the total amount of such refund or**

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[34] See footnote 33, page 299.

[35] *Camp Bird v. Howbert,* 262 Fed. 114. Certiorari denied March 8, 1920, 252 U. S. 579, 64 L. Ed. 725, 40 Sup. Ct. 344.

credit at the rate of one-half of 1 per centum per month to the date of such allowance, as follows: (1) if such amount was paid under a specific protest setting forth in detail the basis of and reasons for such protest, from the time when such tax was paid, or (2) if such amount was not paid under protest but pursuant to an additional assessment, from the time such additional assessment was paid, or (3) if no protest was made and the tax was not paid pursuant to an additional assessment, from six months after the date of filing of such claim for refund or credit. The term "additional assessment" as used in this section means a further assessment for a tax of the same character previously paid in part.

(b) Section 177 of the Judicial Code is amended to read as follows:

"Section 177. No interest shall be allowed on any claim up to the time of the rendition of judgment by the Court of Claims, unless upon a contract expressly stipulating for the payment of interest, except that interest may be allowed in any judgment of any court rendered after the passage of the Revenue Act of 1921 against the United States for any internal-revenue tax erroneously or illegally assessed or collected, or for any penalty collected without authority or any sum which was excessive or in any manner wrongfully collected, under the internal-revenue laws."

It is important to note that the date when interest begins to run varies with certain conditions.

The amendment to the Judicial Code permits interest to be paid on all internal revenue claims allowed by the Court of Claims.[36]

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[36] **[Former Procedure]** Prior to the passage of the 1921 law, the courts had held that in suits against collectors interest was payable from the date of payment of an illegal tax.

Decision. The defendant's contention that interest was not allowable we cannot uphold. We have very lately been told that—

> "No one could contend that technically a judgment of a District Court in a suit against the collector was a judgment against or in favor of the United States." *Sage v. U. S.*, 250 U. S. 33, 39 Sup. Ct. 415, 63 L. Ed. 828 (May 19, 1919).

Consequently no question of allowance of interest or costs as against the sovereign arises and the suit is to be regarded. . . . . as against a private person. . . .

It is also urged that interest should not have been allowed as complained of, because the Commissioner signified his willingness to return that amount to plaintiff. Whether plaintiff would have prejudiced this suit by taking what it could get and suing for the rest is a matter not before us. It is enough to repeat that in this action the defendant, even though he has the United States behind him, is to be treated as a private person. . . . .

New York Life Insurance Co. v. Anderson, decided January 14, 1920,

The Solicitor has recently issued a lengthy opinion dealing with interest on judgment claims. The various points of the opinion are summarized in the official digest which reads as follows:

RULING. 1. Where suit is instituted directly against the United States in the Court of Claims or the District Court for the recovery of internal revenue taxes alleged to have been erroneously or illegally collected, interest is not allowable *on* such judgment, except:

(*a*) Where suit is instituted directly against the United States in the Court of Claims and a judgment is rendered in favor of the claimant, which judgment is thereafter appealed by the United States and affirmed by the Supreme Court, interest is allowable on such judgment at the rate of 4 per centum per annum from the date of filing the transcript of judgment in the Treasury Department up to and including the date of affirmance by the Supreme Court, but in no case shall interest be allowed after the term of the Supreme Court at which such judgment was affirmed. (Sec. 1, Act of September 30, 1890.)

(*b*) Where a suit is instituted directly against the United States in the District Court, sitting as a Court of Claims, interest is allowable at the rate of 4 per centum per annum from the date of such final judgment or decree until the time when an appropriation is made for the payment of the judgment or decree. (Sec. 10, Act of March 3, 1887.)

2. By virtue of section 1324 (b) of the Revenue Act of 1921, interest may be allowed *in* any judgment for the recovery of internal revenue taxes erroneously or illegally collected where suit is brought directly against the United States in the District Court or the Court of Claims, and when so allowed by the court must be refunded with the tax. Where interest is not allowed in the judgment by the court it can not be allowed by way of refund.

3. Where suit is instituted against a collector of internal revenue for the recovery of taxes alleged to have been erroneously or illegally collected interest may be allowed by the court *in* the judgment, and when so allowed must be refunded with the tax. Where interest

263 Fed. 527; affirmed 269 Fed. 1021. A writ of certiorari was granted March 28, 1921 (255 U. S. 568, 65 L. Ed. 790, 41 Sup. Ct. 449). Writ was set aside on April 18, 1921 (256 U. S. 686, 65 L. Ed. 1171, 41 Sup. Ct. 534). The application for the writ was finally denied May 2, 1921 (256 U. S. 696, 65 L. Ed. 1176, 41 Sup. Ct. 536).

The important point to be noted is that the Treasury, after long delay, decided that the taxpayer was right and offered to pay the claim without interest. Since the taxpaper had lost the use of his money for seven years he very properly claimed interest. Upon refusal of the Treasury to pay he brought suit and secured judgment.

is not allowed in the judgment by the court it can not be allowed by way of refund.

4. Interest is allowable against the United States only when specifically provided for by law, and if the law does not provide for interest, a provision in a judgment of a court that the United States pay interest would not be sufficient authority for an administrative officer to pay the same. . . . . (I-39-522; Sol Op. 143.)

If paragraph 1 and subparagraphs (a) and (b) relate only to judgments obtained prior to the effective date of the 1921 law, the author has no criticism to make of this part of the decision. If it was not so intended, then the opinion is erroneous as it is contrary to section 1324 of the 1921 law. The position of the Solicitor is stated in the detailed opinion as follows:

Section 1324 (b) of the 1921 Act in effect simply extends the allowance of interest prior to judgment in the case of suits brought directly against the United States and was not designed to permit of allowance of interest after judgment, nor does said section require that interest be paid; it simply permits the court to allow it, and, where the court does not allow it, it is not to be refunded.

The author does not agree that interest must be allowed by the court in order to be collected.

Section 1324 (a), however, specifically provides "that upon the allowance of a claim for refund . . . . for internal revenue taxes paid, interest *shall be allowed and paid.*" Before a suit can be instituted a claim for refund must be filed. A suit in effect requests the court to compel the Commissioner to make the refund. This opinion will probably never be passed upon by the courts, because the lawyer in drawing his petition always requests judgment with interest.

Any interest received, whether by suit or not, should be credited to interest. Such interest is taxable income.

When suit is brought may the government open up the entire return?—

Ruling. . . . . Where an action for money had and received is brought against a collector of internal revenue for the amount of an additional tax paid on net income, the taxpayer is entitled to recover only such amount as is in reality greater than the tax which should

have been assessed under the law as properly interpreted and applied. The fact that the Commissioner in assessing the tax erroneously allowed some deductions for depreciation does not operate as an estoppel against the collector or against the United States, as it is well settled that no assessment of the Commissioner is necessary for the collection of the tax, at least in a direct action by the United States; nor does it make any difference that an assessment has been made, for in spite of the assessment and of the expiration of the period within which an amended assessment can be made, the United States may still sue for the amount actually due. It is immaterial that suit is in form against the collector, because the recovery in the end comes from the United States, so that even if the collector were personally estopped, that estoppel under the circumstances does not apply against the United States. The conclusion is reached therefore that sums due the United States as determined by the court in suit against a collector of internal revenue are a valid offset as against the amount found due the taxpayer, though such sums include items which the Commissioner did not claim to be due the United States when considering the return for purposes of assessment. (C. B. 1, page 258; T. D. 2882 (2).)

This might have been true so far as the laws prior to the 1918 act were concerned, when the government could bring suit at any time. Section 250 (d) of the 1921 act provides that no suit may be brought by the Commissioner after the expiration of a certain period. See page 218.

If the limitation period has run against the government before any counterclaim is made, it is doubtful if the entire return may be opened up. If a taxpayer filed a claim for refund for a certain item and also instituted suit within the limitation period, the government would certainly contend that the suit could include only the specific item claimed. In other words, after the period had expired, the claim could not be amended to include other items.

Indeed the District Court for the Western Division of the Western District of Missouri[37] has held that a suit may not include items which have not been presented to the Commissioner.

Ruling. . . . . . A taxpayer can not claim a deduction in court for the first time where, in its claim for refund filed precedent to bring-

[37] *Kemper Military School v. Crutchley,* 274 Fed. 125.

ing suit, it did not claim the right to such deduction or assert that it had failed to take it in computing net income in its return, or that it had failed to take credit for it, and where, consequently, a claim for the deduction was never presented to the Commissioner of Internal Revenue for his decision. . . . . (C. B. 4, page 266; Digest T. D. 3164; Ct. D. 11.)

Claim for refund of sums recovered by suit.—The following regulation sets forth the detailed procedure necessary for a taxpayer to secure the refund of taxes or penalties erroneously collected by the government after he has brought suit and secured judgment.

REGULATION. (*a*) Claims by taxpayers for the amount of a judgment representing taxes or penalties erroneously collected should be made on Form 843. The claimant should state the grounds of his claim under oath, giving the names of all the parties to the suit, the cause of action, the date of its commencement, the date of the judgment, the court in which it was recovered, and its amount. To this affidavit there should be annexed a certified copy of the final judgment, a certificate of probable cause, and an itemized bill of the costs paid receipted by the clerk or other proper officer of the court, together with a certified copy of the docket entries of the court in the case or so much thereof as may be required by the Commissioner. When a recovery is had in any suit or proceeding against a collector or other internal revenue officer for any act done by him, or for the recovery of any money exacted by or paid to him and by him paid into the Treasury, in the performance of his official duty, and the court certifies that there was probable cause for the act done by the collector or other officer, or that he acted under the directions of the Secretary of the Treasury, or other proper officer of the Government, no execution shall issue against such collector or other officer, but the amount so recovered shall, upon final judgment, be provided for and paid out of the proper appropriation from the Treasury. . . . . (*b*) If the judgment debtor shall have already paid the amount recovered against him, the claim should be made in his name. There should also be a certificate of the clerk of the court in which the judgment was recovered (or other satisfactory evidence), showing that the judgment has been satisfied and specifying the exact sum paid in its satisfaction, with a detail of all items of costs which were paid by the judgment debtor or for which he is liable. . . . . (Art. 1051.)

Appropriations for paying refunds.—

LAW. Section 1317. **That the paragraph of section 3689 of the Revised Statutes, as amended, reading as follows: "Refunding taxes illegally**

collected (internal revenue): To refund and pay back duties erroneously or illegally assessed or collected under the internal revenue laws," is repealed from and after June 30, 1920; and the Secretary of the Treasury shall submit for the fiscal year 1921, and annually thereafter, an estimate of appropriations to refund and pay back duties or taxes erroneously or illegally assessed or collected under the internal-revenue laws, and to pay judgments, including interest and costs, rendered for taxes or penalties erroneously or illegally assessed or collected under the internal-revenue laws.

Validity of tax may be determined by Bankruptcy Court.— In the cases of *In re General Film Corporation* and *U. S. v. Kellogg*[38] the government filed proofs of claim against the bankrupt for additional taxes and interest. The trustee in bankruptcy objected to the claims and the court disallowed them. The government claimed that the only remedy open to the trustee for correcting any error was to pay the taxes and then proceed under Rev. Stat. Sec. 3226, by appealing to the Commissioner for refund and subsequently bringing suit. It was held that under section 64 (a) of the Bankruptcy Act the government's claims were not to be ordered paid as a matter of course and the trustee remitted to proceedings for refund, but that the validity of the tax was a question to be passed upon by the Bankruptcy Court in the first instance.

The court said:

Decision. We regard this section (Section 64(a) of the Bankruptcy Act) as binding upon the government because it is named therein and, while conferring priority, as giving the bankruptcy court the power to hear and determine any question that arises as to the amount or legality of a tax assessed by it. The provision applies to taxes of all the persons mentioned, and we could not differentiate the government from the other persons in the absence of language justifying it.

But section 3226, U. S. Rev. Stat., could under no circumstances apply to the case under consideration because the trustee is not seeking to maintain a suit for the recovery of internal revenue taxes illegally assessed. *Clinkenbeard v. United States*, 21 Wall. 65, 22

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[38] 274 Fed. 903; see also *In re Anderson*, 275 Fed. 397; affirmed 279 Fed. 525.

L. Ed. 477; *United States v. Nebraska Distilling Co.*, 80 Fed. 285, 25 C. C. A. 418.

Refunds will not be entertained by either Commissioner or courts where a final determination has been had.—Sections 1312 and 1313 of the 1921 law provide that the taxpayer and the Commissioner may by agreement finally close a case. After this agreement has been made, neither may reopen the case. See page 232 *et seq.*

Action to recover when government claims fraud or understatement.—

LAW. Section 1323. That section 3225 of the Revised Statutes of the United States, as amended, is reenacted without change as follows:

"Section 3225. When a second assessment is made in case of any list, statement, or return, which in the opinion of the collector or deputy collector was false or fraudulent, or contained any understatement or undervaluation, such assessment shall not be remitted, nor shall taxes collected under such assessment be refunded, or paid back, or recovered by any suit, unless it is proved that such list, statement, or return was not willfully false or fraudulent and did not contain any willful understatement or undervaluation."[39]

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[39] [Former Procedure] The foregoing section contains a very material improvement in that understatements or undervaluations must be willfully false or fraudulent. In the 1916 law the word "willfully" in the next to the last line and the word "willful" in the last line did not appear.

For text of decisions under 1916 law, see *Income Tax Procedure*, 1920, pages 211-212.

CHAPTER XIII

INFORMATION AT THE SOURCE

The withholding of the tax by the payer of the income has long been a salient feature of the British income tax law, and this plan was incorporated in the first American law in 1913 and continued in the law of 1916. In practice, however, it proved to be unsuited to conditions in the United States and aroused much opposition. In the revision of the law in 1917, which is followed in the 1918 and 1921 laws, a system of "information at the source" was substituted, except as to non-resident aliens and certain corporation mortgage interest. This system requires returns of information concerning certain payments made by individuals and corporations, with the purpose of enabling the government to see that the recipients of some classes of taxable income report and pay taxes thereon.

All persons making such payments should become familiar with the requirements of the law, as penalties are provided for non-compliance. For example, all payments to individuals for salaries, interest or rent amounting to $1,000 or more must be reported on the appropriate forms; and the farmer who pays a foreman $90 a month should be as careful to observe the law as a corporation which pays its president a salary of $9,000 a month.

Returns of *all* payments of $1,000 or more, of every nature, would result in the submission of an immense amount of valueless material. The law therefore gives the Commissioner of Internal Revenue considerable discretion as to the character and form of the information which may be demanded, and the regulations on this subject are quite full and precise.

Classification of Information Returns

Returns of information may be divided for convenience of comment into the following groups:

1. Returns by corporations of dividends paid to stockholders;
2. Returns by brokers of profits or losses of customers;
3. Returns by employers, fiduciaries, lessees, mortgagors or others of all payments of fixed or determinable income, such as salaries, rent, mortgage interest. etc.;
4. Ownership certificates, required in the collection of interest on corporation bonds and dividends on foreign stocks;
5. "Withholding" returns, required in the case of fixed or determinable income payable to non-resident aliens or foreign corporations.

This chapter deals with the first four of these classes of returns. Withholding returns are discussed in Chapter XIV.

Returns by Corporations of Dividends Paid to Stockholders

LAW. Section 254. **That every corporation subject to the tax imposed by this title and every personal service corporation shall, when required by the Commissioner, render a correct return, duly verified under oath, of its payments of dividends, stating the name and address of each stockholder, the number of shares owned by him, and the amount of dividends paid to him.**

REGULATION.[1] When directed by the Commissioner, either specially or by general regulation, every domestic or resident foreign corporation . . . . shall render a return on Form 1097 of its payments of dividends and distributions to stockholders for such period as may be

[1] **[Former Procedure]** There was a similar specific requirement in the 1918 law. The 1917 law specified that the return include information regarding "the tax years and the applicable amounts in which such dividends were earned." This was necessary because in 1917 dividends were taxable at the rates which were in force during the years to which the dividends were applicable, under the rule that dividends were deemed to have been paid out of most recently accumulated surplus (1917 law, section 26).

specified, stating the name and address of each stockholder, the number and class of shares owned by him, the date and amount of each dividend paid him, and when the surplus out of which it was paid was accumulated. (Art. 1060.)

The Commissioner has not yet required such a return by all corporations.

Returns by Brokers

LAW. Section 255. **That every individual, corporation, or partnership doing business as a broker shall, when required by the Commissioner, render a correct return duly verified under oath, under such rules and regulations as the Commissioner, with the approval of the Secretary, may prescribe, showing the names of customers for whom such individual, corporation, or partnership has transacted any business, with such details as to the profits, losses, or other information which the Commissioner may require, as to each of such customers, as will enable the Commissioner to determine whether all income tax due on profits or gains of such customers has been paid.**[2]

REGULATION. When directed by the Commissioner, either specially or by general regulation, every person doing business as a broker shall render a return on Form 1100, showing the names and addresses of customers to whom payments were made or for whom business was transacted during the calendar year or other specified period next preceding and giving the other information called for by the form. (Art. 1065.)

The Commissioner has not yet required such a return by all brokers.

Returns of Fixed or Determinable Income

The law requires returns of information only when the income is fixed or determinable. It is not necessary that the income be annual or periodical, as stipulated in the requirement for withholding.

REGULATION. . . . . (*a*) Income is fixed when it is to be paid in amounts definitely predetermined. On the other hand, it is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. . . . . (Art. 362.)

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[2] [Former Procedure] Reg. 33, 1918, Art. 33, referred to special Regulations 40, governing returns to be made by brokers, but these were apparently never promulgated.

It has been held that where a lease provides for a payment of rental in crop shares, the landlord and tenant sharing proportionately the expenses and dividing the proceeds, such payments are not fixed and determinable and need not be reported.[3]

Commission on account of a single transaction has been held not to be fixed or determinable annual income.[4] Income credited but not paid is subject to the provisions of article 362.[5] Fees for professional services should be included in information returns.[6] Earnings of lawyers and doctors are not usually within the purview of this provision of the law (unless they are paid a regular retainer).[7]

It has been held that cash deposits by a tenant to guarantee the carrying out of the provisions of his lease are not necessarily income for the year in which received, but should be reported as income for the years in which they are applicable as rent.[8]

RULING. A receiver in partition proceedings is required to file returns of information covering payments of commissions, attorney's fees, and other fixed or determinable income of $1,000 or more made to any person during the taxable year. (C. B. 5, page 252; O. D. 1149.)

Persons required to file returns of fixed or determinable income.—

LAW. Section 256. That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, and employers, making payment to another individual, corporation,[9] or partnership, of interest, rent,

Description of payments.—

salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income

[3] Treasury Bulletin "B," page 38; also C. B. 1, page 261; O. D. 115.
[4] C. B. 4, page 232; O. D. 907.
[5] C. B. 2, page 249; O. D. 428.
[6] C. B. 2, page 248; O. D. 416.
[7] Treasury Bulletin "B," page 11.
[8] C. B. I-1, page 324; I. T. 1291.
[9] Payments to corporations need not be reported (Art. 1074).

(other than payments described in section 254 and 255), [The exceptions are dividends and transactions by brokers (see page 309)].

The amount to be reported.—

of $1,000 or more in any taxable year,

Employees of United States government must make return.—

or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for,

Form of returns.[10]—

shall render a true and accurate return to the Commissioner, under such regulations and in such form and manner and to such extent as may be prescribed by him with the approval of the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment. . . .

The regulation dealing with this matter follows:

REGULATION. All persons making payment[11] to another person of fixed or determinable income of $1,000[12] or more in a taxable year must render a return thereof to the Commissioner for the preceding calendar year on or before March 15 of each year, except as specified in articles 1073, 1074, 1075, 1076, and 1079. The return shall be made in each case on Form 1099, accompanied by a letter of transmittal on Form 1096 showing the number of returns filed. The street and number where the recipient of the payment lives should be stated, if possible. Where no present address is available, the last known post-office address must be given. Although to make necessary a return of information the income must be fixed or determinable, it need not be annual or periodical.[13] . . . . (Art. 1071.)

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[10] [Former Procedure] Under the 1913 and 1916 laws there were provisions for withholding at the source for all classes of fixed or determinable annual or periodical income. These withholding returns constituted a source of information, but "information at the source" in the strict sense was first provided for in the 1917 law. This system was substituted when withholding at the source was abolished. The provisions of the 1918 law regarding information were substantially the same as those of the 1917 law.

[11] These returns are required for actual amounts *paid or credited and made available* during the calendar year equal to or exceeding $1,000. (C. B. 2, page 249; O. D. 428.)

[12] [Former Procedure] Under the 1917 law the amount to be reported was an annual aggregate of $800.

[13] When withholding is required the income must be annual or periodical as well as fixed or determinable [Section 221 (a)].

Returns cover calendar year.—

LAW. Section 256. . . . . **The provisions of this section shall apply to the calendar year 1921 and each calendar year thereafter, ...**

The instructions on form 1099 (1920) state:

One of these forms must be filled in for each person to whom income, as described on this form, was paid during the calendar year. . . . .

Returns under systems of "information at source" and "payment at source."—Returns, treated in more detail later, are required of the various classes of withholding agents covered by the regulations.[14]

Corporations paying interest on bonds and similar forms of indebtedness are required to report the amount withheld in any month on or before the 20th day of the following month, using for this purpose form 1012. At the close of the year and on or before March 1 of the following year, these monthly returns are summarized on an annual return, using form 1013.

The monthly returns referred to above are not required by the statute, but are demanded under regulations prescribed by the Commissioner as a convenience in reporting this tax. Their purpose is to enable the Treasury to audit and check from month to month the items therein reported, and thus avoid congestion at the close of the year. The annual reports, however, are required by the statute, and failure to file them subjects the withholding agent to penalties the same as those for failure to file the annual returns of net income.[15] An extension of time may be obtained for filing the list returns in the same manner and for the same reasons as those applying to returns of net income.[16]

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[14] It should be noted that all withholding returns are treated as information returns and are therefore mentioned in this chapter. All information returns, however, are not withholding returns and this distinction should be noted.

[15] See page 147.

[16] See page 69.

Tax withheld from income other than bond interest will be accounted for on income tax form 1042, and separate reports of the payments entered in form 1042 will be made on form 1098.

Employers, tenants and debtors must report annually on form 1099[17] amounts of $1,000 or more, paid for salaries, wages, rents, interest, premiums, etc., during the year. In the case of collection of bond interest and of foreign dividends the report is not limited to amounts in excess of $1,000. As one person, firm or corporation may find it necessary to fill out more than one form 1099, it will be necessary to accompany the forms with a letter of transmittal, which is known as form 1096. The form used for non-resident aliens is form 1098.

Affiliated corporations do not make a consolidated report for purposes of information. Form 1099 is to be used by each corporation separately in reporting payments. However, where two corporations were merged during the year 1921, information returns showing payments made by both corporations should be filed by the continuing corporation.[18]

The present regulation omits the requirement of reporting on form 1096 the aggregate amount represented by the separate form 1099. The revised form 1096 requires only a statement of the number of forms 1099 attached thereto.

Payments to employees.—Returns of information regarding payments to employees, other than those against whom withholding is required, are specifically covered as follows:

Regulation. The names of all employees to whom payments of $1,000 or over a year are made, whether such total sum is made up of wages, salaries, commissions, or compensation in any other form, must be reported. Heads of branch offices and subcontractors employing labor, who keep the only complete record of payments therefor, should file returns of information in regard to such pay-

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[17] For classes of items to be reported, see Chapter XIV.
[18] C. B. I-1, page 324; I. T. 1313.

ments directly with the Commissioner. When both main office and branch office have adequate records, the return should be filed by the main office. In case an employer has a large number of employees and the computation of exact amounts paid during the calendar year will result in an undue hardship, careful estimates may be made on the basis of any representative month, and unless the yearly payment based on this estimate in the case of any employee amounts to $1,000 or more, no return of payments to such employee is required. (Art. 1072.)

The present regulation permits employers who have a large number of employees to make returns on *estimated* payments. The old regulation extended this privilege only to employers having a large number of employees who were being moved from job to job.

To report accurately the payments made to individual employees occasions a great amount of unnecessary expense to many large corporations. It has been ascertained that the production of $1 of tax to the government has cost corporations in some cases as much as $10. The present regulation reduces the labor involved to some extent, but the author is still of the opinion that the needs of the government, in so far as this particular form of information is concerned, would be amply met if corporations were required to report merely the name and address of any employee paid at the rate of $1,000 per annum or over without specifying the exact sum paid.

In many cases employees are being paid a part of their compensation in the form of stock of the employing corporation. However the detailed procedure may be worked out, the result is to give the employee extra compensation in terms of stock at par, or at some fixed value if no par stock is issued. In such cases the market value of the stock received may be different from the value used in determining the amount of stock to be issued. It is a question whether in such cases the corporation should return one amount in its information return as paid the employee, and the employee a different amount, based upon the market value of the stock, in his

individual return, or whether the corporation should use in its form 1099 the figure representing the market value of the stock to the employee. The latter seems to the author the better procedure, although in either case complete harmony between the corporation returns and the individual return is impossible.

If an employer is required under a state law to withhold a tax on an employee's salary, the gross payment before deduction should be reported.

Ruling. In executing Form 1099, an employer who is required to withhold tax from an employee under a State income-tax law, should report on such form the amount of the salary paid to the employee plus the amount of the tax withheld. The employee should report the same amount in his personal return on Form 1040 or Form 1040A as the case may be. (C. B. 2, page 249; O. D. 401.)

The value of living quarters and board furnished employees[19] must be considered by employers in preparing returns of information:

Rulings. . . . . A person receives cash compensation for services rendered, and in addition thereto living quarters; when such quarters are furnished for the benefit and convenience of employees, the amount of cash compensation plus the value of living quarters must be returned. When, however, living quarters are furnished for the convenience of the employer only, the value thereof need not be returned. Board and lodging furnished seamen in addition to their cash compensation is held to be supplied for the convenience of the employer. . . . . (Treasury Bulletin "B," page 38.)

The value to a domestic servant of the board and lodging received as part of his compensation for services rendered is deemed to be the same amount which he would be required to pay for board and lodging elsewhere than in his employer's household.

If the value of the board and lodging added to the cash compensation equals or exceeds $1,000 an employer is required to report such amount on Forms 1099 and 1096. The value of the board and lodging should be entered separately on Form 1099, as evidence of the fact that such value has been considered in computing the total amount received by the servant. (C. B. 4, page 348; O. D. 874.)

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[19] See Chapter XVII. The 1921 law specifically provides that the rental value of a minister's house is not taxable and should therefore not be reported.

In view of the foregoing, employees should be advised by employers regarding the tax to which they are subject.

RETURN OF INFORMATION BY PARTNERSHIPS AND FIDUCIARIES.—Information returns on forms 1099 and 1096 are required in all the above cases regardless of whether such income amounts to more or less than $1,000 annually.[20] Salaries paid to members of partnerships must also be included in the returns of information. Similarly, if a fiduciary receives a salary from an estate, an information return must be filed. All payments by partnerships and fiduciaries to employees must be reported if such payments equal or exceed the statutory minimum.

Many taxpayers object to making information returns for members of partnerships and for beneficiaries, because such information is shown on the partnership return 1065 and the fiduciary return 1041. This duplication of information returns was the subject of a conference at Washington between the Secretary of the Treasury and representative bankers and others. It resulted in the elimination of forms 1096 and 1099 in these cases, as stated in the instructions on the present form 1096.

RULING. A business which had been operated as a partnership was incorporated in June, 1920, and thereafter operated as a corporation. There was no interruption to the business, and the employees of the partnership were retained by the corporation.

Held, that for administrative purposes it will not be considered that there was a change in employer. Since there was no interruption to business, and the employees of the partnership continued to be the employees of the corporation, only one Form 1099 covering the calendar year 1920 is required to be filed in each case where the total amount of payments made equalled or exceeded $1,000. (C. B. 4, page 347; O. D. 788.)

RETURNS OF PAYMENTS TO NON-RESIDENT ALIENS.[21]—

REGULATION. In the case of payments of annual or periodical

[20] See Treasury Bulletin "B," page 39; also C. B. 4, page 348; Mim. 2708.

[21] If the income of non-resident aliens is not fixed or determinable, no information return is required. (C. B. 3, page 312; O. D. 673.)

income to nonresident alien individuals, partnerships composed in whole or in part of nonresident aliens and not having an office or place of business within the United States, or to foreign corporations not engaged in trade or business within the United States and not having any office or place of business therein, the returns filed by withholding agents on Form 1042 shall constitute and be treated as returns of information. . . . . (Art. 1075.)

Form 1042 is the annual list return of the withholding agent which must be filed on or before March 1.

RULING. A withholding agent is not relieved from obligation to pay to the Federal Government the amount of tax correctly withheld from the income of a nonresident alien by reason of the fact that the nonresident alien has filed a return showing no tax liability. (C. B. 5, page 194; O. D. 985.)

Where no return of information on forms 1099 and 1096 is required.—As previously stated, the statute gives the Commissioner discretionary powers as to the class of payments to be reported on information returns 1099 and 1096. The list of specific payments which require no information returns follows:

REGULATION. Payments of the following character, although over $1,000, need not be reported in returns of information on Form 1099: (*a*) payments of interest on obligations of the United States; (*b*) dividends paid by domestic or resident foreign corporations; (*c*) payments by a broker to his customers; (*d*) payments of any type made to corporations; (*e*) bills paid for merchandise, telegrams, telephone, freight, storage, professional services, and similar charges; (*f*) annuities representing the return of capital; (*g*) payments of rent made to real estate agents (but the agent must report payments to the landlord if they amount to $1,000 or more annually); (*h*) payments made by branches of business houses located in foreign countries to alien employees serving in foreign countries; and (*i*) payments made by the United States Government to sailors and soldiers and to its civilian employees. (Art. 1073.)

The instructions on form 1096 state that no return on form 1099 is required in case of "Distributions to members of a partnership . . . . and beneficiaries."

RULING. An employer is not required to report on Form 1099 the amount representing compensation for personal injuries or sickness paid to an employee. (C. B. 4, page 349; Digest O. D. 858.)

Although several types of income paid by states or political subdivisions thereof are exempt from tax, there are numerous instances in which taxable income is paid. Such taxable income must be reported:

Ruling. A department of municipal government is required to file a return of information as provided in section 256 of the Revenue Act of 1918, showing payments of fixed or determinable gains, profits, and income of $1,000 or over in any taxable year, excluding from the return, however, payments made as salary or wages to officials or employees of a State or political subdivision thereof, and payments of interest on the obligations of a State or political subdivision thereof. (C. B. 2, page 249; O. D. 470.)

Ownership Certificates

Information returns of bond interest and foreign dividends not limited to payments of $1,000.—The statutory provision as to information returns in case of bond interest and foreign dividends is as follows:

Law. Section 256. . . . . **Such returns may be required, regardless of amounts, (1) in the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of corporations, and (2) in the case of collections[22] of items (not payable in the United States) of interest upon the bonds of foreign countries and interest upon the bonds of and dividends from foreign corporations by individuals, corporations, or partnerships, undertaking as a matter of business or for profit the collection of foreign payments of such interest or dividends by means of coupons, checks, or bills of exchange. . . . .**

Regulations. The owners of bonds or other obligations, except domestic and resident corporations, whether or not such bonds or other obligations contain a tax-free covenant, issued by domestic or resident foreign corporations, when presenting interest coupons for payment

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[22] [Former Procedure]

Ruling. The term "collections" as used in section 256 of the Revenue Act of 1918 includes the following:

(*a*) The payment by the licensee of the foreign item in cash;

(*b*) The crediting by the licensee of the account of the person presenting the foreign item;

(*c*) The tentative crediting by the licensee of the account of the person presenting the foreign item until the amount of the foreign item is received by the licensee from abroad;

(*d*) The receipt of foreign items by the licensee for the purpose of transmitting them abroad for deposit. (C. B. I-1, page 325; I. T. 1176.)

shall file a certificate of ownership for each issue of bonds, showing the name and address of the debtor corporation, the name and address[23] of the owner of the bonds, the nature of the obligations, the amount of interest and its due date,[24] and the amount of any tax withheld. No ownership certificates need be filed in the case of interest payments on bonds the income from which is not required to be included in gross income, nor in the case of any obligations of the United States. . . . . (Art. 365.)

In the case of payments of interest, regardless of amount, upon bonds and similar obligations of domestic or resident foreign corporations, the original ownership certificates, when duly filed, shall constitute and be treated as returns of information. If a bondholder files no ownership certificate in the case of payments of interest on registered bonds, the withholding agent shall make out such a certificate in each instance and file it with his monthly return. No ownership certificate is required to be filed in case bonds or other obligations are owned by domestic or resident corporations. . . . . (Art. 1074.)

In the collection of interest on corporation bonds, whether in coupon or registered form, the bondholder (unless it is itself a corporation) is required to file an ownership certificate as to each series of coupons or registered interest. One certificate may cover any number of coupons of the same due date and the same issue of bonds.

Ruling. The following is a schedule of ownership certificates required to be used under the Revenue Act of 1921:

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[23] It is not necessary to enter the street address of the debtor corporation on the ownership certificate. (C. B. 3, page 216; O. D. 615.)

[24] Bondholders frequently make the error of entering the maturity date of the bond, instead of the due and payment date of the coupon.

Classification of owner.	Bonds of domestic or resident corporations. Containing tax-free clause.	Not containing tax-free clause.
Citizen or resident of the United States. (Individual or fiduciary.) *Personal exemption not claimed.*	Form 1000, line 1.	
Citizen or resident of the United States. (Individual or fiduciary.) *Personal exemption claimed or interest not subject to tax at the source.*	Form 1001, line 1.	Form 1001, line 2.
Domestic or resident partnership..........	Form 1000, line 2.	Form 1001, line 3.
Nonresident alien. (Individual or fiduciary)	Form 1000, line 3.	Form 1000, line 3.
Partnership composed in whole or in part of nonresident aliens and having no office or place of business in the United States.	Form 1000, line 4.	Form 1000, line 4.
Foreign corporation not having an office or place of business in the United States and not engaged in trade or business therein.	Form 1000, line 5.	Form 1000, line 5.
Unknown owner	Form 1000, line 6.	Form 1000, line 6.

Classification of owner.	Bonds of foreign corporations or foreign Governments. Containing tax-free clause and having paying agent in the United States.	Not containing tax-free clause and whether or not having paying agent in the United States.	Stock of foreign corporations.
Citizen or resident of the United States. (Individual or fiduciary.) *Personal exemption not claimed.*	Form 1000, line 1.	....	
Citizen or resident of the United States. (Individual or fiduciary.) *Personal exemption claimed or income not subject to tax at the source.*	Form 1001A, line 1.	Form 1001A, line 1.	Form 1001A, line 1.
Domestic or resident partnership	Form 1000, line 2.	Form 1001A, line 2.	Form 1001A, line 2.
Unknown owner.....	Form 1000, line 6.	....	

There is no space provided on Form 1001A for reporting income when the owner is unknown. If the foreign item is an interest coupon on bonds not containing a tax-free covenant clause, issued by a foreign Government or a foreign corporation, or is a dividend check on stock issued by a foreign corporation, the procedure set forth in the second paragraph of article 1078, Regulations 62, should be followed. There is ample space on Form 1001A below the word "partnership" for the insertion of the word "unknown" under classification of owner, and for entering the income in the appropriate column. (C. B. I-1, page 222; I. T. 1331.)

The regulations provide that ownership certificates shall constitute and be treated as returns of information; but no ownership certificate is required to be filed in case the bonds are owned by domestic or resident foreign corporations.

Rulings. Where a corporation purchases its own bonds, the trustee under the mortgage canceling at once the bonds and attached coupons, no ownership certificate is required for the accrued interest paid at the time of purchase; nor is an ownership certificate required when the bonds are retained by the corporation to be canceled at the time due, the coupons being canceled at each interest period.

If the bonds are purchased from sinking-funds assets and together with the coupon interest are placed to the credit of the sinking fund which is not under the control of the trustee, no ownership certificate is required. (C. B. I-1, page 219; I. T. 1206.)

. . . . In cases where, under the terms of the indenture, bonds are convertible into stock, if the accrued interest is not paid or credited to the account of the bondholder, but is to be adjusted against the dividend accrued on the stock, no ownership certificate is required to be filed by the bondholder representing the accrued interest. (Letter to the Southern Pacific Company, New York, N. Y., signed by Commissioner D. H. Blair, and dated April 6, 1922.)

Ownership certificates are no longer required in connection with interest payments upon domestic bonds or similar obligations owned by domestic and resident corporations and foreign Governments. Ownership certificates are not required in connection with foreign items owned by nonresident alien individuals, foreign partnerships, foreign corporations, domestic corporations, and foreign Governments. The filing of Form 1098 with respect to income reported on annual return of tax withheld, Form 1042, is not required.

Forms 1099 and 1096 are not required with respect to distributable income of beneficiaries and members of a partnership . . . . as such information is available on fiduciary return, Form 1041, and partnership . . . . return, Form 1065. (C. B. I-1, page 220; Mim. 2921.)

Ownership certificates to cover accrued interest are not required to accompany bonds delivered between interest dates, either for conversion into stock or for payment prior to maturity at a fixed price and accrued interest. (I-35-484; I. T. 1432.)

Inasmuch as no ownership certificates are required in connection with the collection of interest on corporate bonds, except when coupons are presented at maturity, no ownership certificate is required to be filed by the owner of bonds at the time of their conversion into stock. O. D. 949 (C. B. 4, page 234) overruled. (C. B. I-1, page 222; I. T. 1356.)

Duty of banks and other collecting agencies with reference to ownership certificates.—All ownership certificates should contain complete information, or payment should be refused.

The interest of both taxpayers and agents demands this. Taxpayers who fail to file the required form automatically waive the credit which they might otherwise claim for tax constructively withheld at the source. Once a form has been accepted by banks or other collecting agents, the responsibility for its corrections lies with such banks or agents. The certificates should always bear the signature of the owner or his agent. The use of ownership certificates takes the place of information returns 1099 and 1096 so far as bond interest payments are concerned.

Regulation. In the case of payments of interest, regardless of amount, upon bonds and similar obligations of domestic or resident foreign corporations, the original ownership certificates, when duly filed, shall constitute and be treated as returns of information. . . . . (Art. 1074.)

Rulings. If banks and other collecting agents accept coupons for collection to which are attached incomplete or otherwise improperly executed ownership certificates, such banks or collecting agents become a party to the filing of incomplete returns of information and shall upon demand of the debtor furnish the name and address of the owner of the coupons so that such ownership certificates may, when filed, be accepted as returns of information in accordance with the provisions of the regulations issued under section 256 of the Revenue Act of 1918.[25] (C. B. 4, page 232; Digest Mim. 2725.)

Paying agents must not require bank cashing coupons to secure ownership certificates unless law and regulations require certificates. Department cannot prescribe definite ruling for inter-banking transactions. (Telegram to National City Company, New York, N. Y., signed by Commissioner D. H. Blair, and dated March 9, 1922.)

Interest coupons presented without ownership certificates.—

Regulation. When interest coupons are received unaccompanied by certificates of ownership, unless the first bank be satisfied that the owner is a domestic or resident corporation, the first bank shall require of the payee a statement showing the name and address of the payee, the name and address of the debtor corporation, the date of the maturity of the interest, the name and address of the person from whom the coupons were received, the amount of the interest, and a

[25] Also applicable under 1921 law.

statement that the owner of the bonds is unknown to the payee. Such statement shall be forwarded to the Commissioner with the monthly return on Form 1012. The first bank receiving such coupons shall also prepare a certificate on Form 1000, crossing out "owner" and inserting "payee" and entering the amount of interest on line 6, and shall stamp or write across the face of the certificate "Statement furnished," adding the name of the bank. (Art. 369.)

The affidavit form is no longer required, a mere statement only being necessary. If the first bank is satisfied that the owner of the coupon is a corporation, no statement is now required.

Ruling. Bank cashing coupons should exercise ordinary business care in ascertaining owner of bonds in cases where coupons are unaccompanied by ownership certificates. If owner is unknown, certificate should be prepared as required by Article 369. Written statement in lieu of ownership certificate not required in connection with interest payments on bonds owned by domestic or resident corporations. (Telegram to National City Company, New York, N. Y., signed by Deputy Commissioner E. H. Batson, dated March 7, 1922.)

Form of certificate when withholding is required.—Withholding at the source is discussed in detail in Chapters XIV and XLI; but, inasmuch as withholding returns are treated as information returns, it is deemed advisable to state the regulation governing the use of ownership certificate form 1000 (revised).[26]

Regulation. For the purposes of article 365 Form 1000 shall be used (*a*) by citizens or residents of the United States when no personal exemption or credit is claimed against interest on bonds containing a tax-free covenant; (*b*) by nonresident alien individuals, by partnerships composed in whole or in part of nonresident aliens and not having an office or place of business within the United States, and by foreign corporations not engaged in trade or busiess within the United States and not having any office or place of business therein, whether or not such bonds contain a tax-free covenant; (*c*) by partnerships, resident or nonresident, and (prior to January 1, 1922) personal service corporations, in the case of bonds containing a tax-free covenant; and (*d*) where the owner is unknown to the withholding agent. (Art. 366.)

Partnerships are now included under (c) and class (d) is entirely new.

[26] For returns required, see page 311 *et seq.*

Certificates required when there is no withholding.[27]—

Regulation. For the purposes of article 365, Form 1001 shall be used (*a*) by citizens or residents of the United States when personal exemption is claimed against interest on bonds containing a tax-free covenant and when presenting coupons from bonds not containing a tax-free covenant; (*b*) by domestic and resident partnerships, in the case of bonds not containing a tax-free covenant. In case a citizen or resident alien individual receives interest on bonds containing a tax-free covenant in excess of the amount of personal exemption which the individual may claim, any such excess must be reported on Form 1000. (Art. 367.)

Form 1001 is no longer used by domestic corporations, non-resident partnerships, nor by foreign corporations.

Use of substitute certificates.[28]—

Regulation. Resident collecting agents, including responsible banks and bankers receiving interest coupons for collection with ownership certificates attached, may present the coupons with the original certificates to the debtor corporation or its duly authorized withholding agent for collection, or may detach and forward the original certificates directly to the Commissioner, provided each such collecting agent shall substitute for such original certificates its own certificates, Form 1058 or Form 1059, and shall keep a complete record of each transaction, showing (*a*) serial number of item received; (*b*) date received; (*c*) name and address of person from whom received; (*d*) name of debtor corporation; (*e*) class of bonds from which coupons were cut (whether containing a tax-free covenant or not); and (*f*) face amount of coupons. The original certificate for which the certificate of the collecting agent is substituted shall be endorsed, preferably with a rubber stamp, by the collecting agent, as follows:

Owner's certificate No.................

....

(Name of collecting agent.)

.............................., 19....
(Give date of certificate.)

The counterpart of the within certificate bearing like number was attached to the coupons within mentioned for delivery to the debtor or withholding agent, by whom the coupons are payable.

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[27] For returns required, see page 311 *et seq.*

[28] Substitute certificates are favored by persons who wish to conceal the identity of bondholders from the debtor corporation or its paying agent.

For the purpose of identification the substitute certificates shall be numbered consecutively, reverting to the numeral 1 at the beginning of each calendar year, and corresponding numbers given the original certificates of ownership. The use of substitute certificates by collecting agents, banks, and bankers is not permitted, however, in the case of ownership certificates presented with coupons for collection by nonresident alien individuals, partnerships, or corporations. (Art. 368.)

Form 1059 is used instead of form 1000; form 1058, instead of form 1001.

The Treasury places the burden on the bank or collecting agent to see that certificates are properly made out. By accepting an ownership certificate the bank or agent becomes directly responsible for its being made out in accordance with the requirements of the law and regulations.

Ruling. . . . . The attention of the Bureau of Internal Revenue has been invited to the fact that in many instances indifference and carelessness has been shown by owners in executing ownership certificates accompanying coupons presented to banks and other collecting agents for collection of the interest on bonds and other obligations of debtors, and also that banks and other collecting agents have been accepting incomplete and improperly executed ownership certificates with such coupons deposited for collection and have been transmitting same to debtors for payment. . . . .

Banks and other collecting agents are not required by law or regulations to accept interest coupons for collection. If, however, as a matter of convenience to their customers, they do accept interest coupons for collection, it is their duty to see that the ownership certificates which are executed by the owner of the coupons are properly filled out. These ownership certificates cannot be accepted as returns of information unless they are properly filled out and debtors receiving coupons from banks or collecting agents with incomplete or otherwise improperly executed ownership certificates are, under the foregoing quoted provisions of Section 256, authorized to demand that the name and address of the owner of the coupons accompanied by incomplete or otherwise improperly executed ownership certificates shall be furnished before the coupons are paid.

If banks and other collecting agents accept coupons for collection to which are attached incomplete or otherwise improperly executed ownership certificates, such banks or collecting agents become a party to the filing of incomplete returns of information and shall upon demand of the debtor furnish the name and address of the owner of the coupons so that such ownership certificates may, when filed, be ac-

cepted as returns of information in accordance with the provisions of the regulations issued under Section 256 of the Revenue Act of 1918. (C. B. 4, page 232; Mim. 2725.)

Correction of ownership certificates by banks or other collecting agents.—

Ruling. Banks or other collecting agents receiving coupons attached to ownership certificates executed on the wrong form, in order to expedite the collection of the interest, are permitted to transfer the necessary information from the erroneous to the proper form, the following notations being stamped in the lower left-hand corner:

"..............................

(Name and address of bank or collecting agent.)

By ...."

(Name of official executing certificate.)

The original certificate should be forwarded with the certificate executed on the proper form by the bank or collecting agent, the original certificate bearing the notation substantially as follows: "Superseded by ownership certificate Form ....," designating the form of certificate executed by the bank or collecting agent. (C. B. 2, page 192; O. D. 562.)

Ownership certificates to be used by fiduciaries and joint owners.—

Regulation. When fiduciaries have the control and custody of more than one estate or trust, and such estates and trusts have as assets bonds of corporations and other securities, a certificate of ownership shall be executed for each estate or trust, regardless of the fact that the bonds are of the same issue. When bonds are owned jointly by two or more persons, a separate ownership certificate must be executed in behalf of each of the owners. (Art. 374.)

Ownership certificates for payments of registered interest.—

Regulation. Ownership certificates are required in connection with interest upon registered bonds the same as interest upon any other class of bonds. If ownership certificates are not furnished by the owner of the bonds, such certificates must be prepared by the debtor corporation or its withholding agent. (*a*) If the bonds contain a tax-free covenant clause, ownership certificates must be prepared on Form 1000 for the following classes of bondholders: Citizens or residents of the United States, nonresident alien individuals, part-

nerships, whether foreign or domestic, foreign corporations having no office or place of business within the United States. (*b*) If the bonds do not contain a tax-free covenant clause, Form 1000 shall be prepared in the case of nonresident alien individuals, partnerships composed in whole or in part of nonresident aliens and not having an office or place of business within the United States, or in case the owner is a foreign corporation not engaged in trade or business within the United States and not having an office or place of business therein. If ownership certificates are not filed by a citizen or resident of the United States or a resident partnership in connection with interest payments upon registered bonds not containing a tax-free covenant clause, Form 1001 should be prepared by the debtor corporation or its withholding agent.

Regardless of whether the registered bonds do or do not contain a tax-free covenant clause, no ownership certificate is required in connection with such bonds owned by domestic or resident corporations. (Art. 370.)

Ruling. Where bonds owned by domestic or resident corporations are registered in name of individual, ownership certificate Form 1001 required to be filed, altered to show names and addresses of owner and nominee. (Telegram to Philadelphia Association of Stock Transfer Agents, signed by Deputy Commissioner E. H. Batson, dated June 6, 1922.)

Payer has right to demand name and address of recipient of income.—

Law. Section 256. . . . . **When necessary to make effective the provisions of this section the name and address of the recipient of income shall be furnished upon demand of the individual, corporation, or partnership paying the income. . . . .**

Regulation. When the person receiving a payment falling within the provisions of the statute for information at the source is not the actual owner of the income received, the name and address of the actual owner shall be furnished upon demand of the individual, corporation or partnership paying the income, and in default of a compliance with such demand the payee becomes liable to the penalties provided. . . . . [29] (Art. 1080.)

Ruling. Official position of person authorized to sign ownership certificates in behalf of corporation and identity of person signing ownership certificates in behalf of partnership required to be disclosed on certificates. (Telegram to the Southern Pacific Company, New York, N. Y., signed by Deputy Commissioner E. H. Batson, and dated June 16, 1921.)

[29] See page 147.

Use of form 1087 (revised) to disclose ownership.—The proper use of this ownership certificate is most conveniently summarized as follows:

RULING. This ownership certificate [form 1087 (revised)], is designed primarily for the use of a foreign principal to disclose the actual ownership of stock of a domestic corporation registered in the name of his representative in the United States. Unless the disclosure is made to the Commissioner on this form, the record owner will be liable for any additional tax on dividends on stock of domestic corporations or resident foreign corporations. In all cases where the actual owner is a nonresident alien individual, and the record owner a person in the United States, the record owner will be considered for tax purposes to have the receipt, custody, control, and disposal of the dividend income, and must make return for the actual owner, regardless of the amount of income, and pay any surtax found by such return to be due.

When a foreign corporation is the registered owner of stock of a domestic corporation and the actual owner is a nonresident alien, individual or partnership, disclosure of actual ownership should be made on Form 1087 (Revised). This form should be adapted to make disclosure in order that a domestic corporation required to render a return of information as to dividends in accordance with section 254 of the act, may have at its disposal information as to the actual ownership of the stock. . . . . (Treasury Bulletin "B", page 27.)

Ownership certificates not required for interest on obligations of the United States and political subdivisions thereof.—

LAW. Section 256. . . . . **The provisions of this section . . . . shall not apply to the payment of interest on obligations of the United States.**

REGULATION. . . . . No ownership certificates need be filed in the case of interest payments on bonds the income from which is not required to be included in gross income, nor in the case of any obligations of the United States. . . . . (Art. 365.)

Bonds of the War Finance Corporation are not obligations of the United States.[30] Hence ownership certificates are required in collecting interest on such securities. Ownership certificates are not required in case of municipal bonds and such other bonds the interest from which is exempt from tax.

[30] C. B. 1, page 185; O. D. 284.

Miscellaneous rulings regarding duties of banks.—

Ruling. Where a debtor corporation fails to withhold the 2 per cent tax on tax-free-covenant bonds, and the owner has filed Form 1000, there is no obligation on the bank receiving the coupons to withhold the tax, as assessment will be made against the debtor or its withholding agent, based on the tax liability as disclosed by the ownership certificates, Form 1000.

A bank purchasing abroad coupons of bonds issued by domestic corporations will be held prima facie to be the recipient of income. Ownership certificates should therefore be secured from original owners of bonds in order that tax may be withheld as provided by law.

Where a promissory note, signed by a corporation, is left with a bank or trust company for collection, such bank or trust company should not require an ownership certificate to be attached.

Ownership certificates are required to be filed with respect to interest payments upon first-mortgage participation bonds issued by a trust company and secured by a real estate mortgage deposited with the trustee. In cases where coupons of the bonds are not accompanied by ownership certificates, the first bank is required to furnish a certificate. Where no ownership certificates are filed in connection with interest upon such registered bonds, the withholding agent will be required to prepare certificates. (Treasury Bulletin "B," page 31.)

It has been held that in the case of interest payments on overdue coupon bonds, the interest coupons of which have been exhausted, ownership certificates must be filed when collecting interest, in the same manner as if interest coupons were presented for collection.[31]

Use of stamps and facsimile signatures by banks and trust companies.—If proper authorization is obtained from the Commissioner of Internal Revenue, banks and trust companies may use facsimile signatures in executing income tax certificates (substitute or otherwise) issued under their names.[32]

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[31] C. B. 2, page 191; O. D. 392.

[32] Either rubber stamps or printed signatures may be used. This concession was made to facilitate collection of coupons by banks. It avoids much delay and inconvenience.

Information regarding foreign items.—"Foreign items" and the source from which information is obtained are expressly stated as follows:

Definition of "foreign item."—

REGULATION. The term "foreign item," as here used, means any dividend upon the stock of a nonresident foreign corporation or any item of interest upon the bonds of foreign countries or nonresident foreign corporations, whether or not such dividend or interest is paid in the United States or by check drawn on a domestic bank.

Source of information.—

(*a*) Wherever a foreign country or nonresident foreign corporation issuing bonds has appointed a paying agent in this country, charged with the duty of paying the interest upon such bonds, such paying agent shall be the source of information. If such foreign country or foreign corporation has no such agent, then the last bank or collecting agent in this country shall be the source of information. (*b*) In the case of dividends on the stock of a nonresident foreign corporation, however, the first bank or collecting agent accepting such item for collection shall be the source of information. No return of information is required with respect to foreign items owned by a nonresident alien individual, a foreign partnership, or a foreign corporation, provided the first bank or collecting agent is satisfied as to such ownership. In such case the foreign item may be stamped "foreign owner." (Art. 1076.)

License required for the collection of foreign items.—

LAW. Section 259. **That all individuals, corporations, or partnerships undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks, or bills of exchange shall obtain a license from the Commissioner and shall be subject to such regulations enabling the Government to obtain the information required under this title as the Commissioner, with the approval of the Secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both.**

REGULATION. Banks or agents collecting foreign items, as defined in article 1076, and required by article 1079 to make returns of information with respect thereto, must obtain a license from the

Commissioner to engage in such business. Application Form 1017 for such license may be procured from collectors. The license is issued without cost on Form 1010. Foreign items shall not be accepted for collection by any bank or collecting agent so licensed unless properly indorsed or accompanied by proper ownership certificates giving all the information called for by such certificate. . . . (Art. 1111.)

Ownership certificates for foreign items.—

Regulation. When bonds of foreign countries, or bonds or stocks of nonresident foreign corporations, are owned by citizens or residents of the United States, individual or fiduciary, or by resident partnerships, ownership certificate Form 1001A shall be executed by the actual owner or by his duly authorized agent when presenting the item for collection, whether such item is a dividend or an interest payment, except in the case of a foreign country or a foreign corporation having a fiscal agent or a paying agent in this country and issuing bonds which contain a tax-free covenant clause. In such excepted case the fiscal agent or paying agent is required to withhold a tax of 2 per cent from the interest on such bonds and ownership certificate Form 1000, modified to show the name and address of the fiscal agent or the paying agent, should be used, unless the owner (if so entitled) desires to claim exemption, in which case Form 1001A should be filed.[33]. . . . (Art. 1077.)

Domestic corporations are no longer required to execute form 1001A.

Ruling. Ownership certificates representing interest on bonds owned by nonresident aliens, bearing addresses of domestic bankers in lieu of the residences of the aliens, will be accepted. (C. B. 4, page 233; O. D. 908.)

No ownership certificates required for certain foreign dividends.—Following the principle in force under the 1918 law, it is presumed that ownership certificates will not be required in collecting dividends from foreign corporations which are free from normal tax.[34] Ownership certificates will be necessary in the case of dividends from other foreign corporations.[35]

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[33] No attempt is made to tax non-resident aliens on income which simply passes through American banks for collection and is not income derived from sources within the United States. See Chapter XLI.

[34] See sections 216 (a) and 234 (a-6).

[35] For former procedure see *Income Tax Procedure,* 1921, page 253.

Foreign items presented for collection unaccompanied by ownership certificates.—

Regulation. If the foreign item is an interest coupon detached from bonds containing a tax-free covenant clause, issued by a foreign country or corporation having a paying agent in the United States, a statement and ownership certificate, Form 1000, shall be furnished as provided in article 369.

In the case of other foreign items which are received unaccompanied by an ownership certificate and the owner is unknown, a statement shall be required of the payee, showing the name and address of the payee, the name and address of the debtor organization, the date of the dividend check or the maturity of the interest coupon, the name and address of the person from whom the dividend check or interest coupon was received, and a statement that the owner of the securities is unknown to the payee. The first bank receiving such foreign item shall prepare a certificate of ownership, Form 1001A, crossing out the word "owner" and substituting therefor the word "payee." The first bank shall stamp or write across the face of the certificate "statement furnished," adding the name of the bank. Thereupon the statement and certificate shall be forwarded to the Commissioner as provided in article 1079. (Art. 1078.)

Returns of information for foreign items.—The following regulation applies to the use of ownership certificates in the collection of items (not payable in the United States) of interest on the bonds of foreign countries, and interest on the bonds or dividends on the stock of non-resident foreign corporations.

Regulation. In the case of collections of foreign items, regardless of amount, the original ownership certificates, when duly filed, shall constitute and be treated as returns of information. (*a*) In the case of dividends, as to which the first bank or collecting agent is the source of information, it shall detach the ownership certificate and indorse on the item the words, "Certificate detached and information furnished," adding its name and address. When foreign items have been indorsed as above prescribed, the certificates shall be forwarded to the Commissioner on or before the 20th day of the month following that during which the items were accepted, accompanied by a return on Form 1096A showing the number of certificates. An annual return on Form 1096B shall be forwarded to the Commissioner not later than March 15 of each year, on which shall be given a summary of the monthly returns. (*b*) In the case of interest items, as to which the paying agent or the last bank or

collecting agent in this country is the source of information, the ownership certificate shall accompany the coupon to such agent or source of information, who shall forward the ownership certificate to the Commissioner in the same manner as above provided with respect to dividend items. Where ownership certificate Form 1000 is used, a monthly return shall be made on Form 1012 and an annual return on Form 1013, as provided in articles 361-375. . . . . (Art. 1079.)

The name of the paying agent should be shown on forms 1012 and 1013 when they are used to make returns of ownership certificates covering foreign interest. The aggregate amount of foreign items is no longer reported on form 1096A.

The provisions of subdivision (b) above are applicable also to foreign registered bonds.[36]

General

Heavy penalties for failure to furnish information.—The specific penalties for failure or refusal to furnish information were increased in the 1918 law.[37]

Regulation. A penalty of not more than $1,000 attaches for failure punctually to make a required return, whether of income, withholding or information, or to pay or collect a required tax. If the failure is willful, however, or an attempt is made to defeat or evade the tax, the offender is liable to imprisonment and to a fine of not more than $10,000 and costs. See also the act of July 5, 1884. In addition to these specific penalties *ad valorem* penalties are imposed in various cases. An *ad valorem* penalty is assessed and collected as a part of the tax, while a specific penalty is enforceable only by suit. . . . . (Art. 1055.)

[36] C. B. 3, page 313; O. D. 674.
[37] Section 253. The 1921 law re-enacted this section without any change.

CHAPTER XIV

PAYMENT OF TAX AT SOURCE[1]

The framers of the income tax laws of 1913 and 1916 adopted the principle of collection at the source[2] largely on the strength of its success as a feature of British income tax administration. No attempt was made to test first the operation of an income tax in this country by direct collection from the taxpayer. The withholding provisions of these two laws proved burdensome and difficult of efficient administration. Consequently the 1917 law substituted a system of "information at the source" and withholding was completely abolished, excepting only the cases of non-resident aliens and interest on bonds containing a so-called tax-free[3] covenant clause. The withholding provisions of the 1921 law are substantially the same as those of the two laws preceding it.

Section 221 of the 1921 law deals with the payment or withholding of tax at the source. Subdivision (a) thereof deals with the income of non-resident aliens, a subject which is fully discussed in Chapter XLI.

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[1] As the subject of "Information at the Source" has been treated in Chapter XIII, "Non-Resident Aliens," and in Chapter XLI, all questions as to forms of ownership and information certificates required in the various cases and the withholding of tax on income paid to non-resident aliens and the monthly and annual returns required have been omitted from this chapter.

[2] This is variously called "collection at the source," "deduction at the source," "withholding at the source," and "stoppage at the source." Collection at the source was early instituted in British income tax administration to prevent evasion of the law. In the 1920 *Report of the Royal Commission on the Income Tax,* the opinion was emphatically expressed that retention of deduction at the source is necessary to the efficient administration of the revenue. At least 70 per cent of the present British income tax is collected at the source. The Commission also concluded: "We are not satisfied that any system of 'information at the source' would be a practical and efficient substitute for the present system, and it would be a source of trouble and irritation to the community in general."

[3] This term should not be confused with "tax-exempt," which means freedom from taxation—state, local or federal, or all three.

So far as citizens or residents of the United States are concerned, there is now no withholding or payment of tax at the source, except in the case of tax-free covenant bonds. Nevertheless, there has been considerable agitation for its complete abolition and this feature of the law would doubtless have been abolished had it not been for the opposition of bond owners and investment banking houses. After the enactment of the 1913 law many bonds were issued which contained tax-free covenants whereby the debtor corporations agreed to pay interest in full without deducting the amount of tax required to be withheld at the source. Bonds having such covenants commanded a somewhat higher price than they otherwise would. Those who had purchased bonds with this privilege were naturally opposed to any modification of the law which would abolish it. To meet these objections the 1917, 1918, and 1921 laws provided for restricted withholding in the case of tax-free covenant bond interest.

The legal theory of "deduction."—The tax-free covenant clause in bonds has long been a prolific source of misunderstanding and confusion to the average bondholder, notwithstanding the effort of investment houses to clarify its meaning. Perhaps such covenants should be omitted from future issues to avoid the inherent difficulties which attend their use.

Confusion arises chiefly from the necessarily involved legal phraseology of such covenants and the legal fiction of "deduction." The legal fiction is that a tax-free covenant requires the debtor corporation actually to deduct 2 per cent from the amount of the coupon, pay this sum to the government, and then pay the bondholder 98 per cent of his coupon *plus* an additional 2 per cent, if the corporation has agreed to reimburse him to that extent. In practice the corporation pays the coupon in full and *in addition* pays on behalf of the bondholder to the government a tax equivalent to 2 per cent of the amount of the coupon.

Under some tax-free covenants the debtor corporation agrees to reimburse the bondholder only up to 1 per cent of the amount of the coupon. In this case the theory is that 2 per cent is deducted from the coupon and the bondholder is paid 98 per cent of the coupon *plus* a reimbursement of 1 per cent. Practically, the bondholder gets 99 per cent of his coupon and the corporation pays 2 per cent to the government for him.

Limitation of the debtor corporation's liability.—The contention that corporations having tax-free covenants in their bonds contracted to pay the full normal income tax is now mainly of academic interest.

When a corporation has specifically agreed to pay the normal income taxes assessed against the owners of its bonds on the income accruing therefrom, it should be held strictly to such agreement; but obviously such an agreement must be reasonably construed. If by it the corporation agrees to pay only the *federal* income tax it cannot be held liable to pay *state* income taxes. If it agrees to pay a normal tax not in excess of, say, 2 per cent, it is not obligated to pay more even if the normal tax is more. If it agrees to pay any normal tax which may be imposed without limitations as to the rate, it is of course obligated to the extent of any increased normal tax; but this would not require it to pay an "additional tax" if the law imposes a "normal tax" at a certain rate and also an "additional tax."[4]

The usual tax-free covenant obligates the corporation to pay only such normal tax as it is required by law to *deduct and retain* for account of the bondholders. Sometimes the covenant is to pay only up to a sum which is less than it is required to deduct and retain (e. g., 1 per cent, while the deduction now required is 2 per cent). If withholding at the

[4] **[Former Procedure]** Normal taxes imposed by the Act of October 3, 1917, were in addition to those imposed by the Act of September 8, 1916. The Revenue Act of 1918 contained no provision of this kind, prior laws being thereby repealed. This, however, apparently does not constitute an argument for full payment of normal tax.

source were to be entirely abolished, the corporation would not be required by such a covenant to pay any normal tax for the bondholder.

Since the imposition of a high normal tax there has been a tendency to state the actual percentage of tax for which the corporation will make reimbursement. Among such provisions are: "Both principal and interest payable in full without deduction for any federal normal income tax . . . . not in excess of 2 per cent" and "both principal and interest payable in full without deduction for any federal normal income tax . . . . up to 4 per cent." The first clause limits the present and future liability to reimburse to 2 per cent. The second clause limits such future liability to 4 per cent. In other words, if under a future law 6 per cent were the lawful deduction, reimbursement would be made to the extent of 2 per cent under the first clause or 4 per cent under the second. This 4 per cent limitation should not be construed to render corporations liable to 4 per cent under the present law, because 2 per cent is the maximum lawful deduction in the case of a bond containing a tax-free covenant clause.

What is a "tax-free covenant"?[5]—The law defines a tax-free covenant as follows:

LAW. Section 221.[6] . . . . **(b) In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon, or to retain therefrom under any law of the United States.**[7] . . . .

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[5] Tax-free covenants are frequently not limited to federal taxes, but include any state, county or local taxes or impositions which the obligor may be required or permitted to deduct or retain under present or future laws.

[6] Subsection (a) refers only to non-resident alien individuals or partnerships. (See Chapter XLI.)

[7] **[Former Procedure]** Under the 1913 law withholding was required in the case of interest on domestic and foreign bonds and dividends of foreign corporations regardless of amount, and on pay-

By Treasury interpretation, bonds issued under a trust deed containing a tax-free covenant are treated as if they themselves contained such a covenant. It is also held:

Ruling. Where neither bonds nor the trust deeds given by the obligor to secure them contain a tax-free covenant, supplemental agreements executed by the obligor corporation and the trustee containing a tax-free covenant and which modify the original trust deeds to that extent are of the same effect from the date of their proper execution as if they had been part of the original deeds of trust, and the bonds from such date are subject to the provisions of section 221(b) of the Revenue Act of 1918, provided proper authority exists for the modification of the trust deeds in this manner. The authority must be contained in the original trust deeds or actually secured from the bondholders. (C. B. 2, page 187; O. D. 414.)

Amount of tax to be withheld by obligor corporation.—

Law. Section 221. . . . . (b) . . . . the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods. . . . .

From whom tax is withheld.—The law provides that in making payments of interest on tax-free covenant bonds, the obligor shall deduct and withhold a tax equivalent to 2 per cent of the coupon.

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ments of interest, rent, salaries, wages, premiums, annuities, compensations, remuneration, emoluments or other fixed or determinable gains, profits and income amounting to $3,000 or over in any taxable year. Exemption from the withholding provisions of the act could be obtained to the amount of the personal exemption, by filing a certificate with the withholding agent, and a further exemption was permitted by filing a statement of the deductions to which the taxpayer was entitled.

Under the 1916 act the withholding provisions were similar except that the rate was increased from 1 to 2 per cent. However, under the 1917 law withholding was abolished except in the case of nonresident aliens and interest on tax-free bonds, and section 1212 of that act provided for refunding all tax that had been withheld during 1917 except such as had been withheld on tax-free bonds.

Withholding agents did not in all cases promptly release the amounts in their hands, although the law was so clear that no time should have been lost after October 3, 1917, in returning the funds. If withholding agents did not have in their possession the information regarding the legal owner of the bonds to whom repayment was due, they were directed to communicate with the bank through which collection was made, secure the name of the payees and promptly refund the amounts due. (T. D. 2635, January 24, 1918.)

LAW. Section 221. . . . . (b) . . . . whether payable to a nonresident alien individual or to an individual citizen or resident of the United States or to a partnership: *Provided,* That the Commissioner may authorize such tax to be deducted and withheld in the case of interest upon any such bonds, mortgages, deeds of trust, or other obligations, the owners of which are not known to the withholding agent. . . . .

LAW. Section 237. That in the case of foreign corporations subject to taxation under this title not engaged in trade or business within the United States and not having any office or place of business therein, there shall be deducted and withheld at the source in the same manner and upon the same items of income as is provided in section 221 a tax equal to 12½ per centum thereof (but during the calendar year 1921 only 10 per centum), and such tax shall be returned and paid in the same manner and subject to the same conditions as provided in that section: *Provided,* That in the case of interest described in subdivision (b) of that section the deduction and withholding shall be at the rate of 2 per centum.

REGULATION. In general, withholding is required (*a*) of a tax of 8 per cent in the case of fixed or determinable annual or periodical income payable to a nonresident alien individual or to a partnership composed in whole or in part of nonresident aliens and having no office or place of business within the United States, except (1) dividends of a class allowed as a credit by subdivision (*a*) of section 216, (2) interest on deposits with persons carrying on the banking business, paid to persons not engaged in business in the United States and not having an office or place of business therein, and (3) interest upon corporate bonds containing a tax-free covenant clause; (*b*) of a tax of 10 per cent for the calendar year 1921 and 12½ per cent for subsequent years in the case of fixed or determinable annual or periodical income (with the exceptions just stated) payable to a foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein; and (*c*) of a tax of 2 per cent in the case of interest payable to an individual or a partnership, whether resident or nonresident, or to a foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein, upon bonds or other obligations of domestic or resident foreign corporations containing a so-called tax-free covenant clause. Where the owner of bonds or other like obligations is unknown to the withholding agent a tax of 2 per cent must be withheld from interest on so-called tax-free covenant bonds, and a tax of 8 per cent must be withheld from interest on all other corporate bonds or securities. Bonds issued under a trust deed containing a tax-free covenant are treated as if they contained such a covenant. A foreign corporation having

a fiscal agent or paying agent in this country is required to withhold a tax of 2 per cent upon the interest on its tax-free covenant bonds. . . . .

A debtor corporation having an issue of bonds or other similar obligations may appoint a duly authorized withholding agent to act in its behalf, provided notice of such appointment is filed with the Commissioner. (Art. 361.)

"Withholding agent" defined.—

LAW. Section 200. . . . . (3) The term "withholding agent" means any person required to deduct and withhold any tax under the provisions of section 221 or section 237; . . . .

Income subject to withholding.—

REGULATION. Only (*a*) fixed or determinable (*b*) annual or periodical income is subject to withholding. Among such income, giving an idea of the general character of income intended, the statute specifies interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments. But other kinds of income may be included. . . . . (Art. 362.)

FIXED INCOME DEFINED.—

REGULATION. . . . . Income is fixed when it is to be paid in amounts definitely predetermined. . . . . (Art. 362.)

DETERMINABLE INCOME DEFINED.—

REGULATION. . . . . On the other hand, it is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. (*b*) The income need not be paid annually if it is paid periodically, that is to say, from time to time, whether or not at regular intervals. That the length of time during which the payments are to be made may be increased or diminished in accordance with someone's will or with the happening of an event does not make the payments any the less determinable or periodical. A salesman working by the month for a commission on sales which is paid or credited monthly receives determinable periodical income. (Art. 362.)

Exemption from withholding.—Under the law the debtor corporation or its paying agent is required to withhold a tax of 2 per cent on tax-free covenant bond interest paid to individual citizens or residents *who do not claim exemption,* and in the case of resident partnerships. (Withholding on account

of non-resident alien individuals, foreign partnerships and corporations is discussed in Chapter XLI.)

The statute provides that exemption from withholding may be claimed in the following manner:

Law. Section 221.. . . . (b) . . . . **Such deduction and withholding shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1 a signed notice in writing claiming the benefit of the credits provided in subdivisions (c) and (d) of section 216; nor in the case of a nonresident alien individual if so provided for in regulations prescribed[8] by the Commissioner under subdivision (g), section 217.**

Regulation. Withholding from interest on bonds or other obligations containing a tax-free covenant shall not be required in the case of a citizen or resident alien individual if he files with the withholding agent when presenting interest coupons for payment, or not later than February 1 following the taxable year, an ownership certificate on Form 1001 claiming a personal exemption or credit for dependents. . . . . (Art. 363.)

This provision of the law and the use of ownership certificates in its administration are responsible for much of the bondholder's confusion regarding tax-free covenants. In the case of tax-free covenant bonds interest is paid in full regardless of whether exemption is or is not claimed. If exemption is claimed on such coupons, the taxpayer thereby merely serves notice on the debtor corporation that his income is too small to be subject to tax and therefore nothing should be paid to the government on his behalf. If exemption is not claimed, a tax of 2 per cent of the amount of the coupon is paid to the government by the obligor.

Who should claim exemption from withholding?—Individual citizens or residents are privileged to claim exemption from withholding, but partners may not claim such exemption. A resident alien is required, in claiming such exemption, to file in addition a certificate of residence (form 1078, revised) with the withholding agent.

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[8] Section 217 gives the Commissioner discretion in allowing non-resident alien individuals to claim exemption by means of certificates of ownership.

Individual citizens or residents should claim exemption, if the total amount of net taxable income does not exceed their personal exemptions, i.e., $1,000 for a single person, $2,000 or $2,500 for a married person, plus $400 for each dependent.[9] By filing such a claim the individual relieves the debtor corporation from paying a tax not lawfully due.

The debtor corporation's liability under a tax-free covenant covers only the portion of *normal tax* deductible at the source. If, therefore, a taxpayer is subject *only to surtax,* because his lawful deductions exceed the amount of income, if any, subject to normal tax, he should relieve the debtor corporation from making payment to the government in his behalf by filing a claim for exemption in collecting tax-free covenant bond interest. The situation is analogous to the case mentioned in the preceding paragraph.

If an individual who has not claimed exemption at the time of collecting the interest afterwards desires to claim exemption, he may file in writing with the paying agent, at any time prior to February 1 of the succeeding year, his notice claiming exemption. Form 1001 may be used for such notice.

Similarly, an individual who has claimed exemption and subsequently desires not to claim exemption must file notice in writing (form 1000) with the paying agent on or before February 1.

Ruling. A foreign organization which has established its exemption from the payment of income tax in accordance with the provisions of article 511 of Regulations 62 will be permitted to claim exemption from having any tax withheld at the source upon interest payments made on bonds belonging to it. Ownership certificate, Form 1000, revised, is the proper form to be filed with such interest payments, but a notation should be made on the certificate substantially as follows: "As this organization has been declared exempt from the payment of income tax by the Commissioner of Internal Revenue under date of —— the interest entered on this certificate is not subject to withholding," giving the date of the official letter in which the organization was held to be exempt. (I-30-430; I. T. 1399.)

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[9] See Chapter XV for discussion of personal exemption.

No withholding against domestic and resident foreign corporations.—The law does not require withholding from interest on tax-free covenant bonds paid to a domestic corporation or to a foreign corporation having an office or place of business in the United States and engaged in a trade or business therein.[10]

As a rule, in the case of payments of tax-free covenant bond interest to domestic or resident corporations,[11] no payment is made to the government on their behalf; hence the tax-free covenant is of no value to such holders. This feature of the law makes the tax-free covenant less costly to the issuing corporation, since large blocks of bonds are sold to banks, insurance companies, and other corporations.

Apparently, in a few isolated cases, debtor corporations have, inadvertently or otherwise, paid tax on behalf of corporations owning their bonds. Under the 1918 regulations, such payment was allowed as a credit against an owner's normal tax, upon proof of payment.[12]

Withholding obligation on bond interest paid in years after the interest became due.—

RULING. . . . . Bond interest represents income to taxpayer when due and payable in accordance with article 54, Regulations 45.

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[10] Forms 1086 should be retained by a debtor corporation in order that it may have in its possession competent evidence in case it should seek to account for its failure to withhold from the income of a foreign corporation. (Letter to Prentice-Hall, Inc., signed by E. H. Batson, dated June 7, 1922.)

[Former Procedure] Under the 1918 law personal service corporations were taxed like partnerships, as far as was practicable. Consequently, under that law it was proper for debtors constructively to withhold tax in making payment of tax-free covenant bond interest. This is the only exception to the rule that there is no withholding against a domestic corporation.

If the taxation of the stockholders of personal service corporations is held to be invalid, it is not probable that any readjustments for tax-free covenant interest under the provisions of section 1332 will follow. Personal service corporations disappeared as taxable entities after December 31, 1921. Hence, since that date, debtors have not withheld against such corporations. The tax-free covenant no longer has any advantage for personal service corporations.

[11] Excepting personal service corporations during years 1918 to 1921, inclusive.

[12] See *Income Tax Procedure*, 1920, page 246.

No tax required to be withheld from interest upon bonds due prior to March 1, 1913, but paid subsequent to that date. Interest due on and after March 1, 1913, subject to withholding at rates in force at time of payment but in case excess tax is withheld and paid to government claim for refund on form 46[13] will be considered. (Telegram to A. Iselin & Co., New York, N. Y., signed by P. S. Talbert, Acting Assistant to the Commissioner, and dated September 8, 1919.)

From the above it would appear that no withholding is necessary by a debtor corporation in the case of coupons from bonds containing a tax-free covenant clause now presented but due prior to March 1, 1913; but on any coupons maturing subsequent to that date, withholding must be made at the rate in existence at the time of payment. The date of maturity does not determine the rate of withholding. Of course, if an excessive tax is withheld and paid, the bondholder may secure relief by filing a claim for refund.

Withholding at the source of interest on bonds having no tax-free covenant.—The government has taken the position that corporations whose securities do not contain a tax-free covenant must not pay the tax except under supplemental agreements.

RULING. Your telegram May 29. Bonds without tax-free covenant not permitted to be considered tax-free bonds at option of issuing corporation. Corporation only allowed to withhold tax at rate of 8 and 10 per cent from non-resident alien individuals and non-resident alien corporations respectively. Corporation prohibited from paying tax on interest derived from such bonds when owned by citizens or residents of United States. (Telegram to the Farmers' Loan & Trust Company, New York, N. Y., signed by Commissioner Daniel C. Roper, and dated June 2, 1919.)

Withholding in case of partnerships having non-resident alien members.—

REGULATION. The Revenue Act of 1921 provides for withholding in the case of payments made to a partnership composed in whole or in part of nonresident aliens. This provision does not apply to such payments made prior to November 23, 1921. However, in the case of a partnership having an office or place of business in the

[13] Now form 843.

United States, withholding will not be required (except in the case of interest upon tax-free bonds) even though one or more of the members thereof is a nonresident alien; the partnership, however, as agent of the nonresident alien member or members, should file a return of the income of such nonresident alien member or members in accordance with the provisions of article 404. [Art. 371 (a).]

No withholding on interest paid on foreign loans not evidenced by bonds or notes.—Foreign partnerships and corporations are taxable only upon so much of their income as is derived from sources within the United States, determined under the provisions of section 217 of the law.[14] Section 217 (a) lists specific items of income as income from sources *within* the United States, and among others includes "(1) Interest on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise." Section 217 (c) lists specific items of income as income from sources *without* the United States—among other "interest other than that derived from sources within the United States as provided in paragraph (1) of subdivision (a)."

Where a citizen or resident of the United States has borrowed money from a foreign partnership or corporation, but where such borrowing is evidenced only by book entries, and no bond, note, or other interest-bearing obligation has been given therefor, it is the opinion of some authorities that the interest paid or credited thereon is not income from sources within the United States as defined by the law, and is therefore not subject to taxation or withholding.

Returns of withholding.—

Law. Section 221. . . . . (c) Every individual, corporation, or partnership required to deduct and withhold any tax under this section shall make return thereof on or before March 1 of each year and shall on or before June 15 pay the tax to the official of the United States government authorized to receive it. . . . .

Withholding agents liable for deductible taxes.—

Law. Section 221. . . . . (c) . . . . Every such individual, corporation, or partnership is hereby made liable for such tax and is hereby

[14] Sections 213 (c).

indemnified against the claims and demands of any individual, corporation, or partnership for the amount of any payments made in accordance with the provisions of this section. . . . .

When no liability of withholding agent for collecting of tax at source.—

LAW. Section 221. . . . . (e) If any tax required under this section to be deducted and withheld is paid by the recipient of the income, it shall not be recollected from the withholding agent; nor in cases in which the tax is so paid shall any penalty be imposed upon or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

Monthly and annual returns required.—The withholding agent is required to make monthly and annual returns as follows:

REGULATION. (*a*) Every withholding agent shall make an annual return to the collector of the tax withheld from interest on corporate bonds or other obligations on or before March 1 on Form 1013. He shall also make a monthly return on Form 1012 on or before the 20th day of the month following that for which the return is made. The original ownership certificates, or the substitute certificates where authorized, must be forwarded to the Commissioner with the monthly return . . . . the tax withheld must be paid on or before June 15 of each year to the collector. . . . . (Art. 371.)

The ownership certificates are now to be sent to the Commissioner and not to the collector as previously.

If a non-resident alien claims exemption on tax-free covenant bonds on or before February 1 by filing with the withholding agent form 1001B, the amount of tax due from the withholding agent as shown by form 1013 may be reduced by 2 per cent of the aggregate amount of interest payments made to such individual during the calendar year.[15]

When forms 1001 and 1001A are used *there is no actual withholding,* such returns being simply *information returns.* Monthly and annual returns are nevertheless required.

REGULATION. Where a debtor corporation or its duly authorized withholding agent has made payments of interest on its bonds, but

[15] See Chapter XLI.

in certain instances has been required to withhold no tax, the ownership certificates on Form 1001 filed in connection with such payments shall be transmitted to the Commissioner, accompanied by a return on form 1096A showing the number of ownership certificates thus transmitted and the total amount of interest paid. This return shall be made by the 20th day of each month following that for which the return is made and need not be sworn to. An annual return shall be forwarded to the Commissioner not later than March 15 of each year on form 1096B, on which shall be given a summary of the monthly returns. . . . . (Art. 373.)

Tax paid on tax-free covenant bond interest considered income.[16]—The Treasury Department, in 1919, ruled that any tax paid pursuant to a tax-free covenant clause on behalf of a taxpayer should be considered in the nature of additional interest and should be reported by the taxpayer in his return. This ruling was a source of great irritation to the investing public and aroused many protests. The 1921 law, under section 234 (a-3), specifically provides that taxes paid under tax-free covenants shall not be included in the gross income of the taxpayer.

Tax paid on tax-free covenant bond interest not deductible by corporation.[17]—Under section 234 (a-3) of the law, the debtor corporation is not allowed to make deduction for federal taxes so paid under the heading of either interest or taxes.

Credit for taxes paid on tax-free covenant bond interest.—Taxpayers are allowed to credit their total normal and surtaxes with the amount of any tax paid for them at the source by a debtor corporation pursuant to a tax-free covenant clause.[18]

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[16] For discussion, see Chapter XXIV.
[17] For discussion, see Chapter XXIV.
[18] Section 221 (d).

PART II

INCOME

CHAPTER XV

CREDITS AND EXEMPT INCOME

In addition to the deductions from gross income which are fully discussed in Chapters XXX to XXXIX, the tax laws have provided other means of reducing tax liability. Taxpayers in receipt of large incomes are chiefly interested in the various classes of wholly exempt income; taxpayers whose incomes are less than $5,000 are chiefly interested in the specific exemptions. There is this difference between deductions and credits; the former affect surtaxes as well as the normal tax; credits for specific exemptions, dividends and the like reduce only the normal tax. Credits and exempt income are both discussed at this point because the net effect of each is to reduce the amount of taxes which would be due if taxpayers merely reported their gross income.

Income Exempt from Normal Tax Only—"Credits"

The law imposes a normal tax of 8 per cent[1] on the total net income of individuals, and graduated surtaxes upon the larger incomes. It imposes a flat 12½ per cent rate (no surtaxes[2]) upon the income of corporations. Partnerships are not taxed as independent units, the partners instead being taxed upon their respective shares of the profits whether or not distributed.[3] Certain individual income[4] is exempt from the normal tax, but is nevertheless subject to the surtax rates, the adjustment being made by "crediting" (section 216) these

[1] Reduced to 4 per cent on the first $4,000 for citizens and residents. See Chapter IX.

[2] Up to December 31, 1921, there was the excess profits tax in addition, but the flat rate was only 10 per cent from 1919 to 1921. See *Excess Profits Tax Procedure*, 1921, and *Income Tax Procedure*, 1922, pages 161 and 1575.

[3] For a full statement see Chapter XXIX.

[4] Certain dividends, certain interest, and the personal exemptions.

items of income for purposes of the normal tax only. Even in the case of corporations, where no surtax rates apply, there are certain items[5] which, for reasons now obsolete,[6] are entered as "credits" (section 236) rather than as deductions. In this chapter the exemptions and credits alluded to are discussed.

The personal exemptions: wife and dependents.—

LAW. Section 216. . . . . (c) In the case of a single person, a personal exemption of $1,000; or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,500, unless the net income is in excess of $5,000, in which case the personal exemption shall be $2,000. A husband and wife living together shall receive but one personal exemption. The amount of such personal exemption shall be $2,500, unless the aggregate net income of such husband and wife is in excess of $5,000, in which case the amount of such personal exemption shall be $2,000. If such husband and wife make separate returns, the personal exemption may be taken by either or divided between them. In no case shall the reduction of the personal exemption from $2,500 to $2,000 operate to increase the tax, which would be payable if the exemption were $2,500, by more than the amount of the net income in excess of $5,000;[7]

(d) $400[8] for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective.

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[5] The specific exemption of $2,000 on incomes of $25,000 or less, and of certain interest.

[6] The effect was to include these items in the term "net income" when the excess profits tax rates were applied and to exclude them when the income tax rates were applied.

[7] **[Former Procedure]** The 1913 law [section II (C)] and the 1916 law [section 7 (a)] permitted the deduction "for the purpose of the normal tax only" and made the exemption $3,000, plus $1,000 additional if the person making the return were married, with husband or wife living with her or him. The normal tax, which was 1 per cent under the 1913 law, was made 2 per cent in 1916. The 1917 law allowed this arrangement to remain in force, but added what in effect was a second and distinct income tax with an additional normal rate of 2 per cent. For the purpose of this new 2 per cent tax the exemptions of $3,000 and $4,000 provided in the 1916 law were changed to $1,000 and $2,000 (1917 law, Title I, section 3). Consequently there were two sets of exemptions in 1917, one for each normal tax of 2 per cent. The 1918 law provided for one set of exemptions of $1,000 and $2,000 [1918 law, section 216 (c)].

[8] **[Former Procedure]** This is an increase of $200 in the exemption allowed for each dependent under the 1917 and 1918 laws. The 1913 and 1916 laws allowed no exemption for dependents.

The $2,500 personal exemption applies only to those whose net incomes do not exceed $5,000 with the limitation explained in the following example:[9]

Two taxpayers, A and B, married, no children, with net taxable incomes of $5,010 and $5,030 respectively.

The computation of A's tax is made in the following manner:

(1) Net income	$5,010.00	
Personal exemption	2,500.00	
Amount subject to tax	$2,510.00	
Tax at 4%		$100.40
(2) Net income	$5,010.00	
Personal exemption	2,000.00	
Amount subject to tax	$3,010.00	
Tax at 4%		120.40
Excess of computation (2) over (1)		$20.00

Since this amount of $20 is greater than the excess of the net income over $5,000, viz., $10, and since the tax under (2) must not be greater than the tax under (1) by more than the excess of $5,010 over $5,000, i. e., $10, the total tax due by A is, therefore, $100.40 plus $10=$110.40, instead of $120.40.

In the case of B the computations are:

(1) Net income	$5,030.00	
Personal exemption	2,500.00	
Amount subject to tax	$2,530.00	
Tax at 4%		$101.20
(2) Net income	$5,030.00	
Personal exemption	2,000.00	
Amount subject to tax	$3,030.00	
Tax at 4%		121.20
Excess of computation (2) over (1)		$ 20.00

In this instance the reduced exemption does not increase the tax beyond the amount of income over $5,000, viz., $30. The total tax due by B is, therefore, $121.20.

It will be found that the benefit of the provision ceases in case of taxable net incomes over $5,020. The tax on net incomes, of other

[9] For an official illustration, see C. B. I-1, page 200; I. T. 1173.

than single individuals, at and below that figure, but in excess of $5,000, will be computed on the same basis as A above.

TEST OF DEPENDENCY.—

REGULATION. A taxpayer receives a credit of $400[10] for each person (other than husband or wife), whether related to him or not and whether living with him or not, dependent upon and receiving his chief support from the taxpayer, provided the dependent is either (*a*) under eighteen or (*b*) incapable of self-support because defective. The credit is based upon actual financial dependency and not mere legal dependency. It may accrue to a taxpayer who is not the head of a family. But a father whose children receive half or more of their support from a trust fund or other separate source is not entitled to the credit. (Art. 304.)

"HEAD OF A FAMILY" DEFINED.—

REGULATION. A head of a family is an individual who actually supports and maintains in one household one or more individuals who are closely connected with him by blood relationship, relationship by marriage, or by adoption, and whose right to exercise family control and provide for these dependent individuals is based upon some moral or legal obligation. In the absence of continuous actual residence together, whether or not a person with dependent relatives is a head of a family within the meaning of the statute must depend on the character of the separation. If a father is absent on business or at war, or a child or other dependent is away at school or on a visit, the common home being still maintained, the additional exemption applies. If, moreover, through force of circumstances a parent is obliged to maintain his dependent children with relatives or in a boarding house while he lives elsewhere, the additional exemption may still apply. If, however, without necessity the dependent continuously makes his home elsewhere, his benefactor is not the head of a family, irrespective of the question of support. A resident alien with children abroad is not thereby entitled to credit as the head of a family. . . . . (Art. 302.)[11]

The foregoing regulation does not impair the right of a parent to claim the $400 for each dependent irrespective of the nationality or place of residence of the dependents. It refers to the establishment of a $2,500 or $2,000 personal exemption rather than one of $1,000.

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[10] The credit for dependents under the 1917 and 1918 laws was $200. There was no such credit under the 1913 and 1916 laws.

[11] The requirement of residence in "one household" has been abandoned. It had no justification under the law. (C. B. 3, page 194; O. D. 665.) See *Income Tax Procedure*, 1920, pages 31, 32.

When "without necessity the dependent continuously makes his home elsewhere," it may be reasonable to hold that the taxpayer is not to be considered the head of a family. If, however, a resident alien has children abroad "with" necessity, it would seem that, in addition to the credit of $400 for each dependent, the resident alien should be classed as the head of a family because every resident alien individual is subject to the income tax, even though his income is derived wholly from sources outside the United States.[12]

If a taxpayer can qualify as the head of a family under the definition formulated above, he can claim as personal exemption the full $2,500, or $2,000, as the case may be, even though he be not married. On the other hand, it is not necessary that he be the head of a family to claim the $400 for each dependent, provided he supplies the "chief support" of such dependent. Practically every unmarried person who is the chief supporter of a dependent should be able to qualify as a head of a family and avail himself of the additional personal exemption as well as the $400 deduction. A widow or a widower supporting minor children is clearly a "head of a family." A child acting as the main support of a dependent parent or a minor brother or sister is entitled to the additional exemption, plus the $400 exemption for each minor child or dependent person mentally or physically defective. An uncle upon whom nephews and nieces are dependent is entitled to the full exemption for those under eighteen years of age.[13] It has been held that a child over eighteen years of age, away at school, with an income in excess of $1,000 a year (who filed an income tax return claiming exemption of $1,000), but whose income was insufficient to pay half the cost of its support, is "dependent" on its mother (a widow), who is therefore entitled to exemption as the head of a family.[14] A widower with a daughter over eighteen years of age who re-

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[12] Section 210.
[13] C. B. 4, page 215; A. R. R. 551.
[14] C. B. 2, page 159; O. D. 474; also C. B. 4, page 214; O. D. 775.

ceives nominal income from other sources and is neither physically nor mentally incapable of self-support, is head of a family.[15]

In cases where several persons combine to contribute to the joint support of several dependents, it may be desirable to allocate their contributions to particular persons in the group of dependents to the extent of making the taxpayers clearly the main supporters of certain individuals. By so doing they provide a basis for exemption claims which otherwise could not be allowed. This principle has been maintained in a ruling to the effect that where a husband and wife both contribute to the support of a dependent, the credit must be taken by the one contributing the chief support and may not be divided between them.[16] It has been held, further, that when community property is divided between husband and wife in their separate returns and they contribute equally for the support of a dependent, the credit may be claimed by either but may not be divided between them.[17]

Where, in a family group, one claims the exemption applicable to the head of the family, the earnings of minors who are dependent upon him should be included in his return, because the law to this extent contemplates the computation of the tax upon the family as a unit. The following ruling under the 1918 law bears on this point.

RULING. A father has two sons, seventeen and twenty years of age, respectively. During 1919, each son earned in excess of $1,000, but both were dependent upon the father since he appropriated their entire earnings.

In view of the fact that both sons were minors, and had not been emancipated, and their earnings were appropriated by the father, the entire amount of such earnings, together with the father's income from all other sources, must be reported in the father's return for 1919. The credit of $200 for dependents is applicable only to the son under 18 years of age. (C. B. 4, page 214; Digest O. D. 797.)

[15] C. B. 2, page 159; O. D. 422.
[16] C. B. 4, page 214; O. D. 776.
[17] C. B. I-1, page 201; I. T. 1275.

If the father in this case wishes to minimize his tax, he should emancipate the sons, charge them board and have them make tax returns.

MINORS NOT EXEMPT.—A minor as such is not exempt. If he has a substantial income a separate return should be made for him and the $1,000 exemption should be claimed.[18]

RULING. Where a father has made a bona fide and absolute gift of property to his minor child, the income therefrom need not be included in the father's return of gross income for the purpose of normal tax and surtax, even though the father administers the property and collects the income for the child. In such a transaction there is no presumption that the gift is or is not bona fide, but the burden should be upon the father in each case to show that it is an absolute gift to the child. (C. B. 3, page 116; Digest Sol. Op. 14.)

STATUS AT END OF YEAR DETERMINES EXEMPTION.—

LAW. Section 216. . . . . (f) The credits allowed by subdivisions (c), (d), and (e),[19] of this section shall be determined by the status of the taxpayer on the last day of the period for which the return of income is made; but in the case of an individual who dies during the taxable year, such credits shall be determined by his status at the time of his death, and in such case full credits shall be allowed to the surviving spouse, if any, according to his or her status at the close of the period for which such survivor makes return of income.

WHAT CONSTITUTES "LIVING WITH HUSBAND OR WIFE"?—

REGULATION. In the case of a married man or married woman the joint exemption replaces the individual exemption only if the man lives with his wife or the woman lives with her husband. In the absence of continuous actual residence together, whether or not a man or woman has a wife or husband living with him or her within the meaning of the statute must depend on the character of the separation. If merely occasionally and temporarily a wife is away on a visit or a husband is away on business, the joint home being maintained, the additional exemption applies. The unavoidable absence of a wife or husband at a sanatorium or asylum on account of illness does not preclude claiming the exemption. If, however, the husband voluntarily and continuously makes his home at one place and the wife hers at another, they are not living together for the purpose of

[18] See page 101.
[19] See Chapter XLI.

the statute, irrespective of their personal relations. A resident alien with a wife residing abroad is not entitled to the joint exemption. (Art. 303.)

The fact that a husband has been declared mentally incompetent and that his consequent confinement in an institution may be indefinite has no effect on the joint personal exemption.[20]

PERSONAL EXEMPTION VALID FOR NORMAL TAX ONLY.—In computing the surtax, the personal exemption may not be deducted from the net income.[21] Therefore, if all of a taxpayer's income is from dividends or from Liberty bonds (in excess of the exemption allowed by law), it is possible for him to be subject to a surtax while exempt from the normal tax.

PERSONAL EXEMPTIONS OF RESIDENT ALIENS.[22]—An alien resident in the United States is in almost all respects treated exactly as a citizen. He is permitted to take advantage of the personal exemptions in the usual manner.

RULING. An alien residing in the United States permanently, with wife and children residing abroad, is entitled to a personal exemption of only one thousand dollars since he is not living with his wife, but is entitled to a two hundred dollar credit[23] for each child, provided such child is dependent upon and receives its chief support from him and is under eighteen or incapable of self-support because defective. (C. B. 3, page 195; O. D. 640.)

PERSONAL EXEMPTIONS OF WARDS, BENEFICIARIES AND ESTATES.—Wards and other beneficiaries receiving their income from estates are entitled to claim exemption according to their status, and the guardian or trustee when making returns is allowed to deduct this personal exemption from the amount of income derived from the property of which he has charge in favor of each ward or beneficiary who has not

[20] C. B. 3, page 130; O. D. 603.
[21] See section 216, "For purposes of normal tax only. . . ."
[22] For exemptions of non-resident aliens, see Chapter XLI.
[23] $200, as ruling was made under 1918 law.

claimed a personal exemption independently or through another trustee [section 219 (d)]. Where the estate is subject to a tax by reason of income received by it but not distributed during the year, a deduction of $1,000 only (no deductions for dependents) is allowed in computing the tax upon the estate [section 219 (c)]. This is the only instance in which the personal exemption may be claimed by anyone other than the individual taxpayer.[24]

REGULATION. (a) An estate or trust taxed to the fiduciary is allowed the same credits against net income as a single person, including a personal exemption of $1,000, but no credit for dependents. (b) . . . . Each beneficiary is entitled to but one personal exemption, no matter from how many trusts he may receive income. . . . . (Art. 346.)

For a detailed discussion of the subject of fiduciaries, see Chapter XLII.

Specific credit to corporations.—Corporations whose net income does not exceed $25,000 are entitled to a specific credit of $2,000.

LAW. Section 236. That for the purpose only of the tax imposed by section 230 [income tax] there shall be allowed the following credits: . . . .

(b) In the case of a domestic corporation the net income of which is $25,000 or less, a specific credit of $2,000; but if the net income is more than $25,000 the tax imposed by section 230 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000;[25] . . . .

This provision, which corresponds closely to the specific exemption from normal tax extended to individuals, has as one of its effects the entire elimination of the payment of any tax

[24] [Former Procedure] Prior to the enactment of the 1917 law this exemption (but $3,000 in amount) applied to all estates [section 7 (a)], but as amended by that law the exemption was limited to citizens or residents of the United States, excluding non-resident aliens. The 1918 law again permitted the exemptions in the case of all estates, domestic and foreign.

[25] [Former Procedure] Under the 1909 law corporations received a $5,000 exemption and under the 1913, 1916 and 1917 laws none at all. The 1918 law granted one of $2,000.

by a domestic corporation whose net income is less than \$2,000. In case a consolidated return is filed for several corporations, only one \$2,000 specific credit is allowed, and that only if the consolidated net income does not exceed \$25,000.[26]

The application of the credit to corporations whose net income is but little in excess of the \$25,000 is illustrated by the following computations:

EXAMPLE I

CORPORATION A WITH NET INCOME OF \$25,100

(a) The tax, without the specific credit, at 12½%		\$3,137.50
(b) Net income of	\$25,100	
Less: Credit	2,000	
Tax at 12½% on	\$23,100	2,887.50
Excess of (a) over (b)		\$ 250.00

As the limitation imposed by the section precludes the tax computed under (a), \$3,137.50, exceeding the tax computed under (b), \$2,887.50 (an excess of \$250), by more than the income in excess of \$25,000 (\$100), the actual tax in the case of corporation A would be: \$2,887.50 + \$100 = \$2,987.50.

EXAMPLE II

Corporation B with Net Income in 1921 of \$25,300.00

(a) The tax, without the specific credit, at 12½%		\$3,162.50
(b) Net income of	\$25,300.00	
Less: Credit	2,000.00	
Tax at 12½% on	\$23,300.00	2,912.50
Excess of (a) over (b)		\$ 250.00

In this example the excess of (a) over (b), \$250, is not more than the excess of the net income over \$25,000, \$300; the actual tax, therefore, of corporation B remains as computed without the specific credit, i.e., \$3,162.50. The dividing

[26] For a discussion of the credit allowed corporations for excess profits taxes imposed, see Chapter V, *Excess Profits Tax Procedure,* 1921, and *Income Tax Procedure,* 1922, page 1576 *et seq.*

line below and above which the specific credit of $2,000 is effective, or otherwise, is $25,250.

RETURN FOR FRACTIONAL PART OF YEAR.—Corporations filing returns for fractional parts of a year are entitled to a proportionate part of the $2,000 credit even though income placed on annual basis exceeds $25,000.

RULING. The fact that the net income when raised to an annual basis exceeds $25,000 does not destroy the right to a proportionate part of the $2,000 credit, as the right to such credit is determined by the actual amount of the net income shown by the return and not by the amount which is disclosed when the net income is placed on an annual basis. (I-36-493; I. T. 1439.)

FISCAL YEAR 1920-1921.—

RULING. The method of computing the income tax in the case of a corporation having a fiscal year ending in 1921 is prescribed in section 205 (a). If the net income for such year was $25,000 or less, the full credit of $2,000 is allowed in the case of domestic corporations. If, however, the net income exceeded $25,000, the $2,000 exemption is not allowed in computing the tax at the 1921 rate, although the limitation provided for in section 236 (b) should be availed of in cases where it is applicable. (I-43-557; I. T. 1476.)

CREDIT TO CORPORATIONS UNDER CHINA TRADE ACT.—A new section (264) was added to the 1921 Revenue Act by section 21 of the China Trade Act of 1922.

LAW. Section 264. (a) That for the purpose only of the tax imposed by section 230 there shall be allowed, in the case of a corporation organized under the China Trade Act, 1922, a credit of an amount equal to the proportion of the net income derived from sources within China (determined in a similar manner to that provided in section 217) which the par value of the shares of stock of the corporation owned on the last day of the taxable year by individual citizens of the United States or China, resident in China, bears to the par value of the whole number of shares of stock of the corporation outstanding on such date; *Provided;* That in no case shall the amount by which the tax imposed by section 230 is diminished by reason of such credit exceed the amount of the special dividend certified under subdivision (b) of this section.

(b) Such credit shall not be allowed unless the Secretary of Commerce has certified to the Commissioner.

(1) the amount which, during the year ending on the date of filing the return, the corporation has distributed as a special dividend to or for the benefit of such individuals as on the last day of the taxable year were citizens of the United States or China, resident in China, and owned shares of stock of the corporation,

(2) that such special dividend was in addition to all other amounts, payable or to be payable to such individuals or for their benefit, by reason of their interest in the corporation, and

(3) that such distribution has been made to or for the benefit of such individuals in proportion to the par value of the shares of stock of the corporation owned by each; except that if the corporation has more than one class of stock, the certificate shall contain a statement that the articles of incorporation provide a method for the apportionment of such special dividend among such individuals, and that the amount certified has been distributed in accordance with the method so provided.

(c) For the purposes of this section shares of stock of a corporation shall be considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

(d) As used in this section the term "China"[27] shall have the same meaning as when used in the China Trade Act, 1922.

The credit provided above is limited by the proviso that the tax saving by reason of the credit must be distributed as a special dividend to such stockholders who are citizens of the United States or of China and who reside in China, in addition to all other distributions received by them and in proportion to their stock holdings.

China trade corporation dividends; when exempt.—Section 26 of the China Trade Act, 1922, adds a new subparagraph to section 213 (b) of the 1921 law as follows:

Law. Section 213. . . . . (b) . . . . (13) In the case of an individual, amounts distributed as dividends to or for his benefit by a corporation organized under the China Trade Act, 1922, if, at the time of such distribution, he is a citizen of China, resident therein, and the equitable right to the income of the shares of stock of the corporation is in good faith vested in him.

This section applies only to individual stockholders who are both citizens of China and resident therein. All other

[27] For definition of China, see China Trade Act, section 2.

stockholders are required to include such dividends as taxable income, no credit being allowed for normal tax purposes.[28]

Dividends which are exempt from normal tax.—

Law. Section 216. That for the purpose of the normal tax only there shall be allowed the following credits:

(a) The amount received as dividends (1) from a domestic corporation other than a corporation entitled to the benefits of section 262,[29] and other than a corporation organized under the China Trade Act, 1922, or (2) from a foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of section 217;[30]

The above credit applies to individuals and its effect is to exempt dividends from the normal tax even though the paying corporations are exempt from tax.[31] In the case of corporations substantially the same language is used in a clause[32] included among the deductions, which makes dividends received from other corporations non-taxable.[33]

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[28] China Trade Act, section 27.

[29] Refers to limitation of gross income of certain corporations to that derived from sources within the United States. See Chapter XLI.

[30] See Chapter XLI.

[31] [Former Procedure] Under the 1918 law the exemption was limited to dividends received from corporations taxable under that law.

. . . . Dividends received by the holders of the preferred stock of a corporation, all of the common stock being owned by a town, the corporation furnishing water, power, light and heat to the town, are not exempt from normal tax. (C. B. 1, page 93; O. D. 328.)

[32] Section 234 (a-6).

[33] [Former Procedure] Under the 1913 and 1916 laws corporations were not permitted to deduct dividends received from other corporations. The 1917 law, which levied an additional 4 per cent tax on corporations, exempted dividends received by corporations from this rate, but not from the 2 per cent rate of the 1916 law, which continued in force, except as to dividends out of earnings realized during 1913, 1914 and 1915, which were taxable at 1 per cent (see Chapter IX). The exemption was granted in the form of a "credit" (1917 law, war income tax, section 4). The permission given corporations by the 1918 law to deduct dividends had the effect of automatically relieving such dividends from the excess profits tax. This was accomplished by special provision in 1917. A consolidated return in 1917 was permitted only for the purpose of the excess profits tax. For income tax purposes separate returns were required for

Prior to 1921 the situation regarding dividends received by citizens or residents from foreign corporations was anomalous. As long as the distributing corporation was "subject to tax" in the United States, quite independent of the fact that it might actually pay no tax in this country, dividends from such corporations were exempt from normal taxes. The position is now changed so that more than one-half of the income of the foreign corporation must have accrued from sources within the United States.

Foreign corporations receiving more than one-half of their income from sources within the United States should notify their stockholders regarding the right of credit. When stockholders do not receive a notice the credit should not be claimed. If stockholders have reason to think that they should receive the credit, but have received no notice concerning it from the corporation, they should, of course, ask the corporation for information regarding it.

It should be noted that Porto Rico and the Philippine Islands are not included in the term "United States" for the purposes of the statute. Dividends received from corporations taxed in those countries, but having no income from sources within the United States, are not allowed as credits against net income of individuals or gross income of corporations (Art. 1131).

A full discussion[34] of the situation created by the 1921 law

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each corporation, imposing upon each corporation the 2 per cent rate on dividends under the 1916 law which was still in effect. In making a consolidated return for a fiscal year beginning in 1917 and ending in 1918, when the computation was made to determine the tax applicable to the portion of the year falling in 1918, all dividends were deducted in determining net income. The 1918 law, section 234 (a-6), finally relieved corporations from all taxes on dividends received by other corporations.

[34] [Former Procedure] Dividends paid by a personal service corporation from earnings accumulated prior to January 1, 1918, are exempt from the normal tax. Dividends paid by a personal service corporation between January 1 and March 1, 1918 (both inclusive), are deemed to have been paid from the earnings of 1917 [section 201 (e)], but were taxable at the rates of surtax in force in the year in which received, viz., 1918. The result is that as to the dividends received in those two months the stockholders of a personal service corporation were on the same basis as the stockholders of any other corporation.

in connection with dividends and distributive profits of personal service corporations, is given in *Income Tax Procedure*, 1922, Chapter XXIV. It should be borne in mind that dividends from profits of such corporations accumulated between January 1, 1918, and December 31, 1921, are free from both normal and surtaxes, due to the fact that the individual stockholders paid such taxes on their distributive shares for the years in which earned by the corporation.

Interest which is exempt from normal tax.—

LAW. Section 216. **That for the purpose of the normal tax only there shall be allowed the following credits: . . . .**

(b) The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under section 213;

The foregoing section applies to individuals. Corporations may take credit under section 236 (a) for similar interest. The interest here described is that included within the definitions of gross and net income by virtue of the fact that these particular public securities do not fall within the scope of section 213 (b-4-c).

In the case of all the Liberty loans since the first, and of the Victory 4¾ per cent issue, the interest, except that on certain specified amounts, has been made subject to the individual surtaxes and to the excess and war profits taxes. The sections quoted above provide the machinery for exempting the interest from the normal tax of individuals and the corporation 12½ per cent tax and yet rendering it subject to the surtax and excess profits tax. For a full discussion see Chapter XXV.

Exclusions from gross income—general.—Precisely what shall be included within "gross income" is still in the process of adjudication. Stock dividends, for example, which Congress sought to bring within the definition have been excluded by a decision of the Supreme Court.[35]

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[35] *Eisner v. Macomber*, 252 U. S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521.

COMPENSATION FOR PERSONAL INJURY EXCLUDED.—Following the lead of the court in the stock dividend cases, the Solicitor has given an opinion to the effect that receipts in compensation for injury to personal or family rights, such as, alienation of affection, slander or libel of a personal character, or surrender of right to custody of a minor child, are not to be included at all in gross income, not because they are specifically excluded by the statute, but on the more fundamental grounds of the definition of income. The opinion was, in part, as follows:

RULING. . . . . The question presented is whether the following receipts constitute income within the meaning of the sixteenth amendment and the statutes enacted thereunder: (1) Damages for alienation of affections; (2) damages for slander or libel of personal character; and (3) money received by a parent in consideration of the surrender of his right to the custody of his minor child.

All of these items relate to personal or family rights, not property rights, and accordingly may be treated together. Nor is there a material distinction between payment under an agreement of the parties and payment pursuant to a judgment of a court.

. . . .

In the light of these decisions of the Supreme Court it must be held that there is no gain, and therefore no income, derived from the receipt of damages for alienation of affections or defamation of personal character. In either case the right invaded is a personal right and is in no way transferable. While a jury endeavors roughly to compute the amount of damage inflicted, in the very nature of things there can be no correct estimate of the money value of the invaded rights. The rights on the one hand and the money on the other are incomparable things which can not be placed on opposite sides of an equation. If an individual is possessed of a personal right that is not assignable and not susceptible of any appraisal in relation to market values, and thereafter receives either damages or payment in compromise for an invasion of that right, it can not be held that he thereby derives any gain or profit. It is clear, therefore, that the Government can not tax him on any portion of the sum received. This also applies to money received in consideration of the surrender of the custody of a minor child. Holding otherwise would be equivalent to treating as chattels the wife whose affections were alienated and the child whose custody was surrendered.

In the cases cited above, in *Lynch v. Turrish* (247 U. S. 221), and in other cases, the Supreme Court has repeatedly held that gross in-

come does not include everything that comes in. In *Gould v. Gould* (245 U. S. 151), it was held that alimony is not income. Before the enactment of the Revenue Act of 1918, which specifically exempted from gross income damages for personal injuries, it was held that damages for personal injuries due to accident do not constitute income. T. D. 2747 (not published in Bulletin service). Much less should damages for alienation of affections or defamation of personal character be held to constitute income. Slander or libel affecting business reputation or property rights, however, are not considered in this opinion.

I am of the opinion, therefore, that money received, whether under agreement of the parties or pursuant to judgment of a court, on account of damages for alienation of affections or defamation of personal character or in consideration of the surrender of the custody of a minor child, does not constitute income within the meaning of the sixteenth amendment and the statutes enacted thereunder. . . . (C. B. I-1, page 92; Sol. Op. 132.)

ALIMONY EXCLUDED.—A person receiving alimony need not take it into account at all in making an income tax return. Reversing the former procedure of the Treasury,[36] the Supreme Court of the United States[37] in 1917 held that alimony is not to be considered income to the recipient, nor an item of deductible expense to the payer. This, of course, is the final word on the subject.

REGULATION. . . . . Neither alimony nor an allowance based on a separation agreement is taxable income. . . . . (Art. 73.)[38]

Income Exempt from Both Normal and Surtaxes

In section 213, which applies to both individuals and corporations, certain items are definitely excluded from the definition of gross income and consequently need not be reported at all. These items are discussed in order.

Compensation of certain state and federal officers exempt.—Although there is no specific provision in the law

[36] **[Former Procedure]** T. D. 2090 (December 14, 1914) held that alimony was a personal expense, not deductible by the person paying but taxable to the person receiving, the tax being subject to withholding at the source.

[37] *Gould v. Gould*, 245 U. S. 151, 62 L. Ed. 211, 38 Sup. Ct. 53.

[38] See also C. B. I-1, page 92; Sol. Op. 132, quoted above.

exempting from taxation the compensation of any federal or state officers or employees, it has been held that the salaries of the President and federal judges are not subject to taxation if the appointment to office was prior to February 24, 1919.[39] State officers and employees are held not to be taxable as a result of judicial interpretation of the scope of the federal taxing power.[40]

Salaries of the President and United States judges.—The omission in the 1918 and 1921 laws of the specific exemption formerly granted[41] to the President and United States judges raised the interesting question as to whether or not the salaries of these officers (whose compensation is not supposed to be diminished during their terms of office[42]) may be subjected to a federal income tax. The Supreme Court held in *Evans v. Gore,* that ". . . . the fathers of the Constitution intended to prohibit diminution by taxation as well as otherwise— . . . . they regarded the independence of the judges as of far greater importance than any revenue that could come from taxing their salaries. . . . . the tax was imposed contrary to the constitional prohibition, and must be adjudged invalid."

The (acting) Attorney General in an opinion rendered on June 21, 1920 (32 Op. A. G. 248) stated, in part: "I am unable to see, therefore, that there is anything in the recent opinion of the Supreme Court [*Evans v. Gore, supra,*] which

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[39] *Evans v. Gore,* 253 U. S. 245, 40 Sup. Ct. 550, 64 L. Ed. 887.

[40] *Collector v. Day,* 11 Wall. 113, 78 U. S. 113, 20 L. Ed. 122.

[41] [Former Procedure] The 1917, 1916, and 1913 laws contained the following exemption:

LAW. Section 4. The following income shall be exempt from the provisions of this title: . . . . the compensation of the present President of the United States during the term for which he has been elected, and the judges of the Supreme and inferior courts of the United States now in office, and the compensation of all officers and employees of a state, or any political subdivision thereof, except when such compensation is paid by the United States government.

[42] Attorney General Hoar, 13 Op. A. G. 161 (1869). See also *Pollock v. Farmers' Loan and Trust Co.,* 157 U. S. 429, 39 L. Ed. 759, 15 Sup. Ct. 718; 158 U. S. 601, 39 L. Ed. 1108, 15 Sup. Ct. 912.

relieves a judge appointed since the enactment of the income tax law from paying the tax imposed by that law."

It has been ruled that the decision in *Evans v. Gore* does not apply to referees in bankruptcy,[43] judges of territorial courts,[44] retired federal judges[45] and to members of the Board of United States General Appraisers.[46]

Compensation of federal officers in general not exempt.—

REGULATION. . . . . The salaries of Federal officers and employees are subject to tax, except that, in view of the provisions of the Constitution of the United States as construed by the Supreme Court, the salaries of the President of the United States and Federal judges are not subject to a new tax or an increased tax if elected or appointed to office prior to the passage of the taxing statute. The Revenue Act of 1921, however, imposes no new or increased tax upon such salaries; hence the salaries of all Federal judges appointed since February 24, 1919, are subject to the tax imposed by the Revenue Act of 1921. . . . . (Art. 32.)

With the exceptions noted above, the salaries of all federal employees are taxable.

Salaries of state officers and employees exempt.[47]—As a result of judicial interpretation of the scope of the federal taxing power, an implied limitation has been placed upon the power of Congress, prohibiting it from taxing the salaries of state officers.[48] But there has been no interpretation of that power since the passage of the sixteenth amendment. The idea of abandoning this doctrine has therefore found considerable support. If the war had continued, it is probable that the employees formerly specifically exempted would have been specifically taxed. The 1918 bill as it passed the House of Representatives so provided. Senator Simmons, in reporting to the Senate the law as it was finally passed, said: "The

[43] C. B. 3, page 104; O. D. 678.
[44] C. B. 4, page 83; O. D. 899.
[45] C. B. I-1, page 70; I. T. 1243.
[46] C. B. 4, page 83; O. D. 902.
[47] [Former Procedure] The laws of 1913, 1916 and 1917 exempted such compensation.
[48] *Collector v. Day*, 11 Wall. 113, 78 U. S. 113, 20 L. Ed. 122.

Committee amended section 213 (a) so as to require that any . . . . salaries paid be subject to the income tax, leaving the Constitutional question as to the authority of Congress to tax certain salaries to be settled by the courts in any case in which the question may be raised."[49]

The attitude of the Treasury under the 1918 law, the language of which is re-enacted in the 1921 law, is based on an opinion of the Attorney General (31 Op. A. G. 441) and is expressed in the following regulation and decision:

Ruling. . . . . In accordance with an opinion of the Attorney-General, dated May 6, 1919, and based on the well-settled rule that governmental agencies of the states are not subject to taxation by the federal government, it is held that salaries of state officials and salaries and wages of employees of a state are not subject to the income tax imposed by the said Revenue Act of 1918. (T. D. 2843, dated May 17, 1919.)

Regulation. Compensation paid its officers and employees by a state or political subdivision thereof, including fees received by notaries public commissioned by states and the commissions of receivers appointed by state courts, is not taxable. Compensation received for services rendered to a State or a political subdivision thereof is included in gross income unless the person receives such compensation as an officer or employee of a State or political subdivision. An officer is a person who occupies a position in the service of the State or political subdivision, the tenure of which is continuous and not temporary and the duties of which are established by law or regulations and not by agreement. An employee is one whose duties consist in the rendition of prescribed services and not the accomplishment of specific objects, and whose services are continuous, not occasional or temporary. Employees of universities receiving salaries paid in part or in whole from funds available under the Smith-Lever Act of May 8, 1914, who are officers or employees of a State, are not required to return as taxable income the salaries so received. This is also true with respect to the Act of August 30, 1890, relating to colleges for the benefit of agriculture and the mechanic arts, and to the Act of March 2, 1887, relating to agricultural experiment stations in such colleges. . . . . (Art. 88.)

The issue is essentially constitutional—not administrative—and the matter cannot be deemed to be definitely settled until the courts have passed upon it. In view of the Treasury's

[49] Report of Finance Committee to Senate, December 6, 1918, page 6.

position, however, it is difficult to see how the question will be litigated.

Since the 1918 provision was re-enacted into the 1921 law, the Treasury should proceed to collect taxes from state officers and employees. The question would then be settled by the United States Supreme Court.

The compensation of the following has been held to be exempt from tax:

Attorneys employed by state—when relation of employer and employee. (C. B. 5, page 113; O. D. 1099.)
Chief engineer appointed by sewerage commission. (C. B. 1, page 96; O. D. 309.)
County Surveyor. (C. B. 1, page 96; O. D. 33.)
Deputy Sheriff. (C. B. 5, page 106; O. D. 1053.)
National Guard. (C. B. 4, page 112; O. D. 942; but compensation during field training when paid by federal government, is taxable.)
Notary's fees in partnership income. (C. B. 3, page 125; O. D. 648.)
Receiver. Exempt as to fees arising from appointment by state court, but fees from federal appointment are taxable. (C. B. 2, page 99; O. D. 503.)
Referee in drainage appointed by state district judge. (C. B. 2, page 100; O. D. 525.)
Special counsel to state comptroller. (C. B. 2, page 99; O. D. 494.)
Special deputy bank examiners and clerks, State of Washington. (C. B. I-1, page 105; I. T. 1316, but the compensation of attorneys appointed by the State Bank Examiner is not exempt.)
State jurors. (C. B. 2, page 98; O. D. 434.)
Virginia debt commissioners. (C. B. 1, page 96; O. D. 257.)

District of Columbia, territories, etc., are not "states."— The 1917 law (section 23) declares that "nothing in this title shall be held to exclude from the computation of net income the compensation paid any official by the governments of the District of Columbia, Porto Rico, and the Philippine Islands, or the political subdivisions thereof." No definite ruling appears to have been made regarding the status of territories, but apparently the former exemption extended to state employees did not extend to the employees of territories.

RULING. Compensation of teachers of the Territory of Hawaii is subject to income tax under section 213 (a). (C. B. 1, page 66; O. D. 12.)

Salaries in "land-grant" colleges.—Through acts passed in 1862, 1890 and 1914, the last known as the Smith-Lever Act, Congress deeded certain lands and granted certain funds to the states for the support of colleges. The taxability of the salaries of the professors in such colleges turns upon the point as to whether or not these teachers are employees of the state. If they are, their salaries are not taxable[50] even though the salaries are received in whole or in part from Smith-Lever funds, for such funds "lose their identity as funds of the United States by being paid to the states."[51]

REGULATION. . . . . Employees of universities receiving salaries paid in part or in whole from funds available under the Smith-Lever Act of May 8, 1914, who are officers or employees of a State, are not required to return as taxable incomes the salaries so received. This is also true with respect to the Act of August 30, 1890, relating to colleges for the benefit of agriculture and the mechanic arts, and to the Act of March 2, 1887, relating to agricultural experiment stations in such colleges. . . . . (Art. 88.)

War risk insurance and pensions from United States exempt.—

LAW. **Section 213. That . . . . the term "gross income"— . . . . (b) Does not include the following items, which shall be exempt from taxation under this title: . . . .**

(9) Amounts received as compensation, family allotments and allowances under the provisions of the War Risk Insurance and the Vocational Rehabilitation Acts, or as pensions from the United States for service of the beneficiary or another in the military or naval forces of the United States in time of war; . . . .[52]

Dividends on War Risk Insurance policies are not to be

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[50] With regard to their possible tax liability under the 1918 and 1921 laws, see page 369.

[51] T. D. 2668, March 9, 1918.

[52] [Former Procedure] This provision was introduced in 1921. Payments under the War Risk Insurance Act made since June 25, 1918, were exempted by the act under which paid (Reg. 45, Art. 72). Payments under the Vocational Rehabilitation Act were taxable (C. B. 4, page 79; Sol. Op. 97). Pensions were taxable under the 1918 law (Reg. 45, Art. 32).

included in gross income unless the total dividends received to date exceed the total premiums paid. (C. B. 5, page 101; O. D. 1037.)

Pensions received from a state have also been held to be exempt,[53] but those paid by private individuals are taxable.[54]

GOVERNMENT PENSIONS TO WIDOWS ARE GIFTS.—

RULING. Held, that pensions paid by the United States Government to widows of soldiers, as such, are not taxable income for the reason that such pensions are not awarded as compensation for services rendered to the United States Government by the widows and are mere gifts or gratuities. (C. B. 4, page 84; O. D. 957.)

Accident and health insurance and damages exempt.—

LAW. Section 213 (b). **(6) Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness;**[55] . . . .

The foregoing exemption extends to the estate or other beneficiaries in case the insured is deceased.

REGULATION. . . . . (c) Whether he be alive or dead, the amounts received by an insured or his estate or other beneficiaries through accident or health insurance or under workmen's compensation acts as compensation for personal injuries or sickness are excluded from the gross income of the insured, his estate and other beneficiaries. Any damages recovered by suit or agreement on account of such injuries or sickness are similarly excluded from the gross income of the individual injured or sick, if living, or of his estate or other beneficiaries entitled to receive such damages, if dead. . . . . (Art. 72.)

Proceeds of life insurance policies.—

EXTENT TO WHICH EXEMPT WHEN PAID TO BENEFICIARIES.[56]—

LAW. Section 213. (b) . . . . **(1) The proceeds of life insurance policies paid upon the death of the insured;**[57] . . . .

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[53] C. B. 2, page 98; O. D. 434.

[54] Art. 32.

[55] This exemption, first introduced in 1918, resulted from court interpretations of earlier laws. See *Income Tax Procedure,* 1920, page 40.

[56] For exemption of insurance companies, see Chapter XLIII.

[57] [Former Procedure] The 1913 law exempted "the proceeds of life insurance policies paid upon the death of the person insured" [section

This provision definitely exempts the proceeds of all life insurance to whomsoever paid upon the death of the insured.[58]

In the case where the beneficiary voluntarily left the proceeds of a policy with the company, drawing only 3 per cent interest per annum, the principal, upon the death of the beneficiary, to go to the beneficiary's legal representative, the proceeds were held to be "loaned" to the insurance company and the interest thereon was held to be taxable.[59]

In a similar case, however, where a widow was to receive interest upon the face of the policy together with any dividends apportioned thereto, the proceeds to go to beneficiaries named in the policy upon the death of the widow, the annual payment was held to be part of the proceeds and not taxable.[60]

It has also been held that where a first beneficiary is to receive 6 per cent per annum of the face of the policy, and, upon the death of the first beneficiary, the face value of the policy is payable to a second beneficiary, the payments to the first beneficiary are part of the proceeds of the policy and not taxable.[61]

Amounts received by an individual beneficiary or by the estate of the insured under the terms of an ordinary life and continuous instalment bond contract issued by a life insurance company are likewise exempt from tax.[62]

The provision was made by the insured that the principal of the policy be held by the company as trustee for the benefit of the widow during her life and upon her death for the

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11 (B)]. Under the 1916 and 1917 laws (section 4) insurance payable to the estate of the insured was taxable. The regulations under the 1918 law attempted to tax the proceeds paid to the estate of the insured, but this was reversed by T. D. 3190, July 1, 1921. The 1918 law exempted insurance paid to individual beneficiaries or to the estate of the insured, but excluded from the exemption payments to corporations.

[58] Policies payable to partnerships (except limited partnerships of the corporate type) are in effect payable to individual beneficiaries. (C. B. 1, page 82; T. B. R. 22.)

[59] C. B. 3, page 120, O. D. 612.

[60] *Ibid.*

[61] C. B. 2, page 90; O. 995.

[62] C. B. 2, page 91; O. D. 433.

benefit of the son until he reached the age of 30 years. The principal was not to be withdrawn by the widow during her life nor by the son until he reached the age of 30, unless the interest therefrom for the period of a year, fell below 4½ per cent, when the beneficiary had the right to draw all that part of the principal on which the beneficiary was entitled to draw interest income.

In this case it was held that interest received by the widow during her life or by the son prior to his reaching the age of 30, so long as the income was not less than 4½ per cent of the principal, was exempt from tax. But if the income fell below 4½ per cent, the income was taxable to the beneficiary regardless of whether the principal was withdrawn or left in the hands of the company. Any interest received thereafter was taxable whether more or less than 4½ per cent. The yearly income would be taxable to the son upon arriving at the age of 30 years.[63]

The law says "*proceeds* of life insurance policies" are exempt. These interpretations of the Treasury are of interest, but the courts may take a different view.

EXTENT TO WHICH EXEMPT WHEN PAID TO THE INSURED.—

LAW. Section 213. . . . . (b) . . . . (2) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract; . . . .

Dividends received on life insurance policies that have not matured, whether such dividends are drawn in cash by the insured or applied to the reduction of the annual premium due, are not considered items of taxable income under the law and should be excluded from a return of income. The same rule applies to dividends declared on endowment and other policies until the maturity of the contracts.

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[63] C. B. 5, page 100; O. D. 1010.

In the case of paid-up policies, taxpayers receiving dividends should enquire as to how much represents a return of the "loading" and how much represents excess interest earnings. The former is not taxable, but the latter is taxable as interest.

REGULATION. . . . . (*b*) During his life only so much of the amount received by an insured under life, endowment, or annuity contracts as represents a return, without interest, of premiums paid by him therefor is excluded from his gross income. . . . . (Art. 72.)

The law does not specify the method of reporting the amount received by the assured under an endowment or cancelled policy in excess of premiums paid. As is apparent from the regulations quoted above, the Treasury holds that the entire amount received in excess of premiums paid is taxable income for the year during which received. If in any case, say of an endowment contract, the March 1, 1913, surrender value is greater than the aggregate premiums paid to that date, the taxpayer should add to such March 1, 1913, value the premiums paid to maturity, only the excess over such total being taxable. This is in line with the provision of section 202 (b).

During the years prior to maturity or payment, if the individual keeps his books upon the accrual basis, there would seem to be no objection to reporting each year's accrual so that upon collection of the principal sum there will be no necessity for reporting in one year the entire excess above premiums paid. In the case of large endowment policies this point is important.

Gifts and inheritances exempt.[64]—

LAW. Section 213. . . . . (b) . . . . (3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income), ...

[64] The 1921 law attempts to tax donees on gains realized by sales. See Chapter XXII. This provision, if valid, makes a radical change in the consideration of gifts.

Regulation. Money and real or personal property received as gifts, or received under a will or under statutes of descent and distribution, are exempt from tax, although the income therefrom derived from investment, sale, or otherwise is not. . . . . An amount of principal paid under a marriage settlement is a gift. . . . . (Art. 73.)

The foregoing section merely states that the value of property acquired by gift need not be included in gross income. A tax on property acquired by gift would be a property tax and could not be held to be income, as income has been defined by the United States Supreme Court, nor taxed as such. The 1921 law attempts to tax *such part* of the *proceeds* of gifts as represents accrued gain at the date of the gift (see Chapter XXII). It is claimed that the gift itself is not taxed but only the untaxed gain contained in the gift. Against this is the contention that the imposition of a so-called income tax on donees based on a time and a base over which donees have no legal control, and usually no knowledge at all, is purely and simply a tax on the capital interest with which donees become seized at the date of gift.

It should be noted that no attempt is made to tax gifts as such; the tax referred to only becomes effective when, as and if donees sell or exchange the property acquired by gift.

This chapter deals only with exempt income. It may be said therefore that, as in all other income tax laws, property acquired by gift is exempt from the income tax.

If money or other property is acquired in a manner about which there is a doubt, the transaction may be inquired into. If it is determined that legal consideration is an element, the value of the property may be wholly or in part income, depending on the circumstances of each case.

It is apparent that in many cases the proper course of action for the recipient of a gift which might seem to be somewhat in the nature of compensation for services rendered is determined by the action of the person who made the payment. If the giver desires to deduct the item as an expense, the recipient can scarcely object to reporting any payment of

this nature actually received as taxable income. Here, as in so many cases, good faith and a disposition to yield on really doubtful points are essential to the successful administration of the income tax law.

Bequests to executors in lieu of commissions have been held to be non-taxable.[65]

In the following ruling the taxpayer would seem to have derived income from some source other than property or services; the decision is questionable.

RULING. The taxpayer sold for x dollars a one-sixth interest in an expected inheritance from her father, who was living at the time of sale and had made no will.

Held, that the entire amount received should be treated as income for the period in which received. (I-41-543; I. T. 1466.)

Transactions in which the element of taxability is stronger than that of exemption are discussed in the appropriate chapters dealing with income from services, gains or sales, etc. Gifts which have been held to contain no element of taxable income are illustrated by the following rulings.

RULINGS. Personal transportation passes issued by a railroad company to its employees and their families, to be used when not engaged on business for the company, and which are not provided for in the contracts of employment, are considered gifts and the value thereof does not constitute taxable income to the employees. (C. B. 4, page 110; O. D. 946.)

The assignment by a husband to his wife, in consideration of love and affection, of all commissions on renewal premiums under a certain contract with an insurance company constituted a gift thereof to the wife and they should not be included in her return. The amount of such commissions paid to her should, however, be included in gross income in the return of the husband. (C. B. I-1, page 97; Digest I. T. 1339.)

The foregoing ruling appears to recognize the assignment but actually ignores it. If the assignment is valid, the subsequent receipts are not income at all to the husband, and prior to 1921 were income to the wife only as to the excess received

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[65] *Merriam et al. v. U. S.*, 282 Fed. 851. Writ of certiorari granted, U. S. Sup. Ct. Oct. 16, 1922

by her above the commuted value on the date of the gift. Under the 1921 law the receipts would all be income to the wife provided there was no element of March 1, 1913 value, nor other diminution in taxable status to the husband.

RULING. Held, that the question as to whether a gift from husband to wife is bona fide must be considered in the light of the intent of the donor, from all available facts, and that where a transfer is made by unconditional endorsement of securities, failure to record the transfer on the books of the corporations and the deposit of income from such securities in a joint account, are not conclusive that the gift was colorable. (C. B. 4, page 107; Digest A. R. R. 367.)

COLORABLE GIFTS.—It is reasonable to insist that gifts must be irrevocable and *bona fide* in order that subsequent realized gains or income will be taxed to the donees instead of to the donors. Usually the element of consideration controls. Where there is no family relation (where the consideration of "love and affection" is sufficient) it should be shown that the consideration is reasonable.

In the case of bequests the element of consideration does not enter, and no attempt has been made to tax as income property acquired by bequest.

RULING. The following rules should be followed by the Bureau of Internal Revenue in distinguishing a case of an actual gift and a case of a merely colorable gift:

(a) Where it appears that the owner of property has purported to transfer it without consideration to a member of his own family, or to any other person with whom he is in confidential relations, and that shortly thereafter a profitable sale of the security or property so transferred has occurred, such facts constitute prima facie evidence that the purported gift was not an actual gift and that the transfer was, in fact, merely colorable. In such case the so-called gift should be ignored in calculating tax, and the case should be investigated for evidence on which a charge of fraud could be supported in a contest.

(b) The prima facie case made out by the facts mentioned in the preceding paragraph may be rebutted by proof which establishes that it was not a transaction primarily for the advantage of the donor, and that there was no agreement or understanding, tacit or otherwise, that the donor was to receive back the proceeds or at any time control their disposition. Mere statements by the parties to the effect

that the gift was genuine are regarded as of little weight; the best proof that a gift was a real gift would consist of facts showing that the position or relationship of the parties is such as to show a reasonable occasion for such a gift being made, and such as to explain the sale by the donee. Inquiry should be made as to the disposition of the proceeds.

(c) Where a taxpayer purports to make a gift to a member of his family or to a person in a confidential relation to himself, but no sale occurs, the question whether such gift was real or merely colorable is one to be decided on all of the facts. The mere fact that such conveyance is made may not lawfully be regarded as proof of fraud; but if the effect of the gift is to diminish tax liability, and it appears, either at the time of the gift or at any time thereafter, that the donor is deriving advantage from the property which he purported to give away, such facts constitute prima facie evidence that the gift was only colorable and the transaction should be treated as a nullity unless other facts are developed which show that it was a true gift. If such a gift is colorable only and made for the purpose of escaping tax, the donor is guilty of fraud and subject to penalty and punishment therefor. (C. B. 1, page 83; Digest S. 1022.)

This is clear and reasonable. It reveals no intention to tax the proceeds of sales by donees when the gifts are bona fide. For the provision of the law designed to obviate tax evasion through colorable gifts, see Chapter XXII.

When a so-called pension[66] is a gift.—

Rulings. The terms "pension" and "gift" are not mutually exclusive. A payment may be both a pension and a gift.

When a pension is given by one for whom services are performed in consideration of such services, even though it be granted after the services have been rendered, the pension is not a gift but in the nature of additional compensation.

When, however, so-called pensions are awarded by one to whom no services have been rendered, such payments become mere gifts or gratuities and do not constitute taxable income. Payments by the Carnegie Foundation for the Advancement of Teaching, made to teachers and the widows of teachers, fall into the latter class. Law opinion 560 is modified to conform hereto. (C. B. 2, page 73; O. D. 361, overruled.) (C. B. 3, page 120; Digest L. O. 1040.)

A corporation paid to the widow of a deceased officer a certain amount equal to the salary he would have earned in two months.

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[66] Military and naval pensions from the United States are now exempt [section 213 (9)].

The payment was without consideration, a gratuity voted as a compliment to the deceased. It is held that the payment does not constitute taxable income. (C. B. 5, page 101; O. D. 1017.)

Rental value of residence occupied by clergy is not taxable income.—

LAW. Section 213. . . . . the term "gross income"— . . . .

(b) Does not include the following items, which shall be exempt from taxation under this title: . . . .

(11) The rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel as part of his compensation; . . . .

This exemption appeared for the first time in the 1921 law.

The value of quarters furnished to chaplains of the Army and Navy is not to be included in gross income.[67] Only missionaries who have been ordained as ministers of the gospel are entitled to the exemption.[68]

Interest which is exempt from both normal and surtaxes.—

LAW. Section 213 (b). . . . . (4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia;[69] or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916,[70] or (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit), and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue therof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt to the taxpayer from income, war-profits and excess-profits taxes; . . . .

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[67] C. B. I-1, page 110; I. T. 1307.

[68] C. B. I-1, page 110; I. T. 1306.

[69] [Former Procedure] The words "Territory" and "District of Columbia" were specifically included for the first time in the 1918 law. Under the 1916 law the word "State" was defined to "include any Territory, the District of Columbia," etc., "when such construction is necessary to carry out its provisions." (1916 law, section 15.)

[70] [Former Procedure] This clause was introduced by the 1916 law (section 4).

Regulation. Among income exempt from tax is interest upon the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia. Obligations issued for a public purpose by or on behalf of the State or Territory or a duly organized political subdivision acting by constituted authorities duly empowered to issue such obligations, are the obligations of a State or Territory or a political subdivision thereof. The term "political subdivision" denotes any division of the State or Territory made by the proper authorities thereof acting within their constitutional powers for the purpose of carrying out a portion of those functions of the State or Territory which by long usage and the inherent necessities of government have always been regarded as public. Political subdivisions of a State or Territory, within the meaning of the exemption, include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of a State or Territory. The purchase by a State of property subject to a mortgage executed to secure an issue of bonds does not render the bonds obligations of the State, and the interest upon them does not become exempt from taxation, whether or not the State assumes the payment of the bonds. (Art. 74.)

The precise degree to which the interest on the various issues of United States bonds is exempt from taxation is fully treated in Chapter XXV. Suffice it here to say that the only totally exempt securities are state and municipal bonds of any date, Farm Loan bonds, United States securities issued prior to September 1, 1917, the 3¾ per cent securities of the Victory Loan, postal saving certificates of deposit, and obligations of possessions of the United States. Totally tax-exempt interest need not be included in "gross income" at all.

Rulings. In some of the Western States irrigation districts are created by an election duly called for the purpose. The county assessor of the county in which the land benefited is located assesses all such property on the assessment rolls of the county and a tax is levied and collected in the same manner as other taxes are levied and collected.

Held, the district is a political subdivision of the State and interest on its bonds is exempt from income tax. (C. B. 2, page 93; O. D. 544.)

Interest received on certificates of indebtedness known as "Fire relief certificates" issued in the State of Minnesota, is considered in-

terest upon the obligations of a State and therefore not taxable. (C. B. 1, page 83; O. D. 30.)

Certificates of sale issued by a county or other political subdivision of a State in connection with the sale of property for nonpayment of taxes do not fall within that class of obligations of a State, county, or municipality, the income from which is exempt from Federal income tax. (C. B. 1, page 83; O. D. 327.)[71]

Interest on promissory notes of a political subdivision of a State or Territory is exempt from tax. . . . . (C. B. 4, page 110; Digest O. D. 817.)

A municipality borrows money from a bank, issuing to the bank its promissory notes at a discount. It is provided that if the notes are not paid when due, they will also draw interest from maturity until paid.

Held, that both the discount and the interest on the notes after maturity are exempt from income and profits taxes in the hands of the bank. (C. B. 4, page 110; O. D. 856.)

Bonds were issued by a municipality of Wisconsin, in accordance with the general city charter law of that State, to cover deferred installments of assessments against real estate for the cost of certain public improvements. Each bond was a lien upon all the property benefited to the extent of unpaid assessments and interest thereon. The bonds contained recitals that they were chargeable only to the particular property described therein, and that they should in no event constitute a general city liability.

Notwithstanding the bonds were not a general liability of the city, they were issued by the city for public purposes . . . . and the interest upon such bonds is accordingly exempt from tax. (C. B. 2, page 93; O. D. 447.)

Interest received by a contractor on paving assessments issued to him by a municipality in payment for work under the provisions of the statutes of a certain State is exempt income. . . . . (C. B. 5, page 102; O. D. 999.)

Interest on bonds issued by agricultural and horticultural societies under authority of section 7852, compiled laws of Michigan, is not exempt from tax. . . . . (C. B. 5, page 102; O. D. 983.)

The interest received upon Philippine 4 per cent bonds of 1914-34 is exempt. . . . . (C. B. 4, page 111; O. D. 922.)

Where the executors under a will hold property specifically bequeathed to a governmental agency of a State, and other assets of the decedent's estate are sufficient to pay all debts, income received

[71] See also C. B. 5, page 103; O. D. 1114 for similar ruling upon Wisconsin certificates of sale.

by the executors during the period of administration from such property is not taxable in the hands of the executors. . . . . (C. B. 2, page 96; S. 1374.)

In the ruling last quoted the question at issue was the taxability of income from property specifically bequeathed to a state university, but still held by the executors during the period of administration.

RULINGS. The interest on bonds issued pursuant to an act of the General Assembly of Indiana of March 3, 1921, establishing the Indiana Board of Agriculture is exempt from federal income tax. (C. B. I-1, page 98; I. T. 1270.)

Agricultural corporations organized under chapter 152 of the Montana Session Laws, 1921, are fundamentally private and not public corporations, and interest on obligations issued by them is not exempt from income tax. (C. B. I-1, page 98; I. T. 1194.)

The bonds of a domestic corporation operating exclusively in a possession of the United States, the interest of which but not the principal of which is guaranteed by the government of that possession, do not fall within that class of obligations of the United States or its possessions the income from which is exempt from Federal income tax.

The interest upon such bonds is considered income from sources within the United States. (C. B. I-1, page 99; I. T. 1228.)

For the procedure with reference to interest and discounts on tax-exempt bonds sold or redeemed, see Chapter XXIV.

INTEREST ON AWARDS BY STATE OR MUNICIPALITY.—When a state or city takes property under the power of eminent domain, or when other awards of a state or city are paid with interest, the question arises as to whether or not interest on an award is equivalent to interest on an obligation and therefore is exempt from federal taxes.

The liability of a city to pay for property taken under the power of eminent domain is certainly an obligation. State constitutions provide that private property shall not be taken for public use except upon just compensation paid or secured. A city is allowed to give its own bond and under the obligation of this bond it is compelled to pay just compensation. Such just compensation is due as of the date of the taking,

and when not paid immediately the citizen is placed in the same position by the payment of interest as such, or by the payment of an additional amount, which in some cases is spoken of as "damages for detention" not exceeding legal interest, but which in substance is interest. It is, of course, of importance to the recipient that any part of the award which actually is tax-exempt interest should be properly designated.

Certain dividends exempt from both normal and surtaxes.—

Federal land bank and farm loan association dividends exempt.—

Regulation. As section 26 of the Federal Farm Loan Act of July 17, 1916, provides that every federal land bank and every national farm loan association, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate, and that farm loan bonds, with the income therefrom, shall be exempt from taxation, the income derived from dividends on stock of federal land banks and national farm loan associations and from interest on such farm loan bonds is not subject to the income tax. . . . . (Art. 75.)

Ruling. Interest on bonds issued by joint-stock land banks, organized under the provisions of the Federal Farm Loan Act approved July 17, 1916, is exempt from Federal taxation. Cash dividends received on shares of stock issued by such joint-stock land banks are subject to surtax. (C. B. I-1, page 99; I. T. 1349.)

Federal reserve bank dividends.—

Regulation. As section 7 of the Federal Reserve Act of December 23, 1913, provides that federal reserve banks, including the capital stock and surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate, such exemption attaches to and follows the income derived from dividends on stock of federal reserve banks in the hands of the stockholders, so that the dividends received on the stock of federal reserve banks are not subject to the income tax. Dividends paid by member banks, however, are treated like dividends of ordinary corporations. (Art. 76.)

Compensation for active war service.[72]—No exemption for war service is allowed under the 1921 law. The

[72] *Income Tax Procedure,* 1921, page 51 *et seq.* The exemption did not apply to the Public Health Service (C. B. 5, page 114; T. D. 3242).

exemption allowed under the 1918 law expired automatically with the Joint Resolution of Congress dated March 3, 1921. The period of its effectiveness extended from January 1, 1918, to March 3, 1921.[73] For state bonus payments, see below.

Dividends or interest from domestic building and loan associations exempt within limit.—

LAW. Section 213. That . . . . the term "gross income"— . . . .

(b) Does not include the following items, which shall be exempt from taxation under this title: . . . .

(10) So much of the amount received by an individual after December 31, 1921, and before January 1, 1927, as dividends or interest from domestic building and loan associations, operated exclusively for the purpose of making loans to members, as does not exceed $300;

The ambiguity of the $300 limit is discussed in Chapter XXIV. Dividends from building and loan associations which are not exempt may be taken as a credit in computing normal tax.[74]

Shipowners' mutual protection and indemnity associations.—

LAW. Section 213. . . . . (b) . . . . (12) The receipts of shipowners' mutual protection and indemnity associations, not organized for profit, and no part of the net earnings of which inures to the benefit of any private stockholder or member, but such corporations shall be subject as other persons to the tax upon their net income from interest, dividends, and rents; . . . .

Mutual marine insurance companies, as such, receive certain exemptions.[75] The above specific provision brings the organizations of shipowners into line with those of farmers and others wherein protection is sought without any design to secure other monetary benefits to the members.

BONUS FROM STATE NOT TAXABLE.—

RULING. A bonus paid by a State to its residents who served in the military or naval forces during the war with Germany does not

[73] C. B. 4, page 112; O. D. 900.
[74] I-29-413; I. T. 1394.
[75] See Chapter XLIII.

constitute taxable income to the recipient. (C. B. 1, page 83; O. D. 286.)

The exemption is based on the ground that the bonus is a gift.

Income of foreign governments exempt.—

Law. Section 213. (b) . . . . (5) The income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States; . . . .

Regulation. The exemption of income of foreign governments applies also to their political subdivisions. Any income collected by foreign governments from investments in the United States in stocks, bonds, or other domestic securities, which are not actually owned by but are loaned to such foreign governments, is subject to tax. . . . . (Art. 86.)

Ruling. Income derived by a foreign corporation from sources within the United States is subject to Federal tax, regardless of the fact that 51 per cent of its stock is owned by a foreign Government. If such income comes within the classes contemplated by sections 221 and 237, it is subject to withholding. . . . . (C. B. 4, page 111; O. D. 958.)

Income of foreign ambassadors and ministers—to what extent exempt.—

Regulation. . . . . The income from investments in the United States in bonds and stocks and from interest on bank balances received by ambassadors and ministers accredited to the United States and the fees of foreign consuls, are exempt from tax, but income of such foreign officials from any business carried on by them in the United States would be taxable. As under international law the benefits and immunities of ambassadors and ministers of foreign countries extend to the members of their households, including attachés, secretaries, and servants, the foregoing provision is likewise applicable to the wives and minor children of foreign ambassadors and ministers and the members of their households. The compensation of citizens of the United States who are officers or employees of a foreign government is, however, not exempt from tax. (Art. 86.)

The authority for this exemption is not found in the law. If the ambassadors, ministers and consuls were abroad, their

income from the United States from the sources mentioned would be subject to withholding. It is not clear why the usual "courtesy" exemption from personal taxes, such as customs duties, should be extended to withholding on account of income taxes. As an embassy is deemed to be foreign soil, those who reside in it should be taxed as if they were actually on foreign soil.

Although formerly ruled to the contrary,[76] the privileges afforded foreign diplomatic officers have been extended to embrace their wives and minor children.[77]

RULINGS. Only foreign diplomats, ambassadors, and other diplomatic representatives in charge who are accredited to the United States to represent their sovereign or country and who reside here, and the members of their staff are entitled to exemption from tax on income from investments in bonds and stocks and from interest on bank balances. Foreign consuls resident in the United States are not entitled to the exemption. (C. B. 1, page 91; O. D. 336.)

The fee received by a foreign consul as administrator of the estate of a fellow countryman by appointment of a domestic court is not a consular fee and is not exempt from Federal income tax. (C. B. I-1, page 103; Digest I. T. 1254.)

Territorial Exemptions

The income tax applies, first, to individual citizens and residents of the United States and to domestic corporations (those created or organized within the United States), and second, to non-resident alien individuals and to foreign corporations so far as their income arises from sources within the United States. A person whose stay in the United States is only temporary is not considered a resident.

The law states that "the term 'United States' when used in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia" (section 1). This definition, it will be noted, does not include

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[76] C. B. 1, page 90; O. D. 153.
[77] C. B. 5, page 104; O. D. 1115.

Porto Rico or the Philippine Islands,[78] which have their own income tax laws.

REGULATION. (*a*) A citizen of the United States who resides in Porto Rico, and a citizen of Porto Rico who resides in the United States, are taxable in both places, but the income tax in the United States is credited with the amount of any income, war profits, and excess profits taxes paid in Porto Rico. . . . . (*b*) A resident of the United States, who is not a citizen of Porto Rico, is taxable in Porto Rico as a nonresident alien individual on any income derived from sources within Porto Rico, but the income tax in the United States is credited with the tax paid in Porto Rico. (*c*) A resident of Porto Rico, who is not a citizen of the United States, is taxable in the United States as a nonresident alien individual on any income derived from sources within the United States, and receives no such credit. . . . . The same principles apply in the case of the Philippine Islands. (Art. 1132.)

The same principle applies in the case of corporations similarly situated (article 1133).

It is to be noted that under the provisions of an Act of Congress, known as "An Act making appropriations for the naval service for the fiscal year ended June 30, 1922, and for other purposes,"[79] it was "*Provided further,* That the income tax laws now in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in the Virgin Islands of the United States, except that the proceeds of such taxes shall be paid into the treasuries of said islands." This act was ratified and confirmed from and including July 1, 1921.

[78] [Former Procedure] The 1916 law states "that the word 'state' or 'United States' when used in this title shall be construed to include any territory, the District of Columbia, Porto Rico, and the Philippine Islands, when such construction is necessary to carry out its provisions" (section 15). The 1917 law imposing the war income tax did not extend to Porto Rico and the Philippines, as is shown by the following section: "That the provisions of this title shall not extend to Porto Rico or the Philippine Islands, and the Porto Rican or Philippine Legislature shall have power by due enactment to amend, alter, modify or repeal the income tax laws in force in Porto Rico or the Philippine Islands respectively."

The 1918 law continued this provision. See also *Lawrence v. Wardell,* quoted in C. B. 3, page 73; Ct. D. 1.

[79] Public Law, No. 35, 67th Congress.

Exemption of Profits from Sales of Vessels

The provision in the Merchant Marine Act of 1920[80] exempting for ten years from tax the gains arising from the proceeds of certain vessels referred specifically to the taxes imposed by the Revenue Act of 1918. Of course, the "Revenue Act of 1921" is not the "Revenue Act of 1918," but as the Merchant Marine Act is still in force and as the exemption was to be for ten years, it should be held that the gains to be exempted are the *same* as those imposed by the Act of 1918 and that full exemption should be granted for the ten-year period.

The Treasury has held that the sale of the entire capital stock of a company owning ships, even though the proceeds of such sale were reinvested in American ships, could not be brought within the privileges of the act on the ground that the law specifically provides that the exemption applies only to the sale of ships.

Income from operation of ships documented under laws of foreign country.—

LAW. Section 213. . . . . (b) . . . . (8) **The income of a non-resident alien or foreign corporation which consists exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States; . . . .**

See further Chapter XLI.

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[80] [Former Procedure]

LAW. "That during the period of ten years from the enactment of this Act any person a citizen of the United States who may sell a vessel documented under the laws of the United States and built prior to January 1, 1914, shall be exempt from all income taxes that would be payable upon any of the proceeds of such sale under Title I, Title II and Title III of the Revenue Act of 1918 if the entire proceeds thereof shall be invested in the building of new ships in American shipyards, such ships to be documented under the laws of the United States and to be of a type approved by the board [i. e., the United States Shipping Board provided for by Section 3 of the Act.]

"'Merchant Marine Act, 1920,' of which the above is the second paragraph of Section 23, approved by the President, June 5, 1920. (Merchant Marine Act, 1920, section 23, paragraph 2.)"

CHAPTER XVI

INCOME IN GENERAL

Plan of treatment.—In the following thirteen chapters are discussed in detail the various types of income subject to the income tax. Income from personal services, business, property, interest, rents, dividends, etc., are taken up in regular order and the procedure peculiar to them is explained. However, in addition to these particular subjects there are many questions which are general in their nature and application. These are brought together for treatment in this introductory chapter.

Variations according to class of taxpayer.—It should be observed that, unless otherwise indicated, statements made in the text are to be accepted as applying to corporations and individuals alike. So much of the procedure applies to all classes of taxpayers that it has been deemed desirable to isolate only the exceptional points, indicating plainly in such cases the limitations upon the application.

"Catch-all" provision.—The law states (section 213) that "gains or profits and income derived from any source whatever" are subject to the tax. To provide for possible lapses in the law and regulations the following "catch-all" provision was included in a previous edition of the regulations. The statements made are still pertinent.

Regulation. The intent and purpose of the income-tax law is that all gains, profits, and income of a taxable class shall be charged and assessed with the corresponding income tax, normal and additional, and such tax shall be paid by the owner of such income or the proper representative thereof having the receipt, custody, control, or disposal of the same. In any case where the conditions which obtain do not appear to fall within the law and regulations for the

assessment and collection of the income tax, the proper tax shall be assessed in the particular case by the Commissioner of Internal Revenue upon his findings concerning the same. Ownership of income and liability for tax thereon shall be determined as of the year for which the return is required to be rendered. (Reg. 33, 1918, Art. 49.)

Nature of taxable income.—The concept of income adopted in the law is not an entirely clear and logical one. In general it imposes the tax only when the income is reduced to money, but in certain cases this rule is not followed, the law taxing some income in forms other than money.[1]

What is needed is an authoritative definition of "income." This cannot be found in the decisions of the Supreme Court, because they contain too many differentiations and limitations to make clear what a decision will be in any future case.

The following definition of income is of interest. It should, however, include the world "realized" when applied to taxable income:

> Income is the money value of the net accretion to one's economic power between two points of time.[2]

It appears from some court decisions that doubt exists as to the taxability of certain transactions which involve so-called capital. The Circuit Court of Appeals, Second Circuit, held that a gift to a corporation is not taxable income.[3] In defining the word "income,"[4] the court said: ". . . . it

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[1] The 1917 and former laws purported to tax only realized income but the Treasury assessed taxes on many exchanges in which there was no realized income. The 1918 law contained a formula for computing income in the case of exchanges which depended more on par or face value of securities than on actual values.

[2] Robert Murray Haig, "The Concept of Income—Economic and Legal Aspects," *The Federal Income Tax*, Columbia University, 1921.

[3] *U. S. v. Oregon-Washington R. & Nav. Co.*, 251 Fed. 211.

[4] "However, the tax, though it includes income 'from all sources,' nevertheless includes 'income' only, and the meaning of that word is not to be found in its bare etymological derivation. Its meaning is rather to be gathered from the implicit assumptions of its use in common speech. The implied distinction, it seems to us, is between permanent sources of wealth and more or less periodic earnings. Of course, the term is not limited to earnings from economic capital; i.e., wealth industrially employed in permanent form. It includes the earnings from a calling, as well as interest, royalties, or dividends,

(income) should not include such wealth as is honestly appropriated to what would customarily be regarded as the capital of the corporation." One judge, dissenting, said: "I find no difficulty in calling it (the gift to the corporation) income."

Under the circumstances, no apology is needed to justify a careful inquiry into the right of Congress or of the Treasury to extend the taxation of income—which is permitted under the sixteenth amendment—to the taxation of capital—which is not permitted. Such an inquiry naturally should cover the right to tax any transaction unless there is an actual realization of income, as distinguished from the apparent income which may be, and often is, the result of temporary fluctuations in values.

INCOME IN CASH OR EQUIVALENT.[5]—The use one enjoys of his own property—as, for example, the house in which the owner lives—is not considered taxable income. Ordinarily income, to be taxable, must be in the form of money. Thus, the farmer's crop is not taxable until it has been reduced to cash (if the inventory method is not used)[6] and one piece of property exchanged for another when neither has a "readily realizable market value,"[7] gives rise to no immediate taxable income. However, income from personal services is taxable "in whatever form paid."[8] This is true apparently on the theory that in these cases there is some basis for the determination of the cash value of the income even though the income itself is in a form other than money, such as accounts receivable or mortgages.

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though in the case of corporations this may be of slight importance. Yet the word unquestionably imports, at least so it seems to us, the current distinction between what is commonly treated as the increase or increment from the exercise of some economically productive power of one sort or another, and the power itself, and it should not include such wealth as is honestly appropriated to what would customarily be regarded as the capital of the corporation taxed."

[5] See Arts. 33 and 34, pages 430 and 424.

[6] See Chapter XLIV.

[7] Section 202 (c).

[8] Section 213 (a).

Regulation. . . . . Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. . . . . (Art. 22.)

Closed transactions in property.—The attempt to tax accretions of property values has raised an interesting series of problems turning upon the question: What constitutes a closed transaction or a realization definite enough to serve as the basis for the imposition of a tax? This topic is discussed in detail in Chapter XXI.

"Gross" and "net" income.—The 1921 law devotes, in the case of individuals, one section to the enumeration of the items included and not included in the term "gross income" (section 213) and another to "deductions" (section 214), and declares "net income" to be the remainder obtained by deducting the second from the first. The items, such as dividends, personal exemptions and interest on certain government securities, which are subject to the surtaxes but not to the normal tax, are provided for by a series of "credits" described in another section (section 216). As a result "gross" income is a special term which excludes, by specific direction of the statute, certain items such as gifts and proceeds of insurance policies paid upon the death of the insured, and which likewise excludes, on grounds of the fundamental definition of income, such items as alimony and damages received for personal injuries. (See page 366.) "Net" income is also a special term which, in the case of individuals, includes personal exemptions, dividends, etc. The same general plan is followed in defining the "gross" and "net" income of corporations (sections 232-236).

The explanation in the regulations of the concepts of gross and net income is as follows:

Regulation. The tax imposed by the statute is upon income. In the computation of the tax various classes of income must be considered: (*a*) Income (in the broad sense), meaning all wealth which

flows in to the taxpayer other than as a mere return of capital. It includes the forms of income specifically described as gains and profits, including gains derived from the sale or other disposition of capital assets. Income can not be determined merely by reckoning cash receipts, for the statute recognizes as income-determining factors other items, among which are inventories, accounts receivable, property exhaustion, and accounts payable for expenses incurred. . . . . (*b*) Gross income, meaning income (in the broad sense) less income which is by statutory provision or otherwise exempt from the tax imposed by the statute.[9] . . . . (*c*) Net income, meaning gross income less statutory deductions. The statutory deductions are in general, though not exclusively, expenditures, other than capital expenditures, connected with the production of income.[10] . . . . (*d*) Net income less credits.[11] . . . . The surtax is imposed upon net income; the normal tax upon net income less credits. Though taxable net income is a statutory conception it follows, subject to certain modifications as to exemptions and as to deductions for partial losses in some cases, the lines of commercial usage. Subject to these modifications statutory "net income" is commercial "net income." This appears from the fact that ordinarily it is to be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer. . . . . (Art. 21.)

Income accrued prior to March 1, 1913, not taxable.—

Regulation. Any claim existing unconditionally on March 1, 1913, whether presently payable or not and held by a taxpayer prior to March 1, 1913, whether evidenced by writing or not, and all interest which had accrued thereon before that date, do not constitute taxable income, although actually recovered or received subsequent to such date. Interest accruing on or after that date is taxable income. Where an interest-bearing claim held on February 28, 1913, is paid in whole or in part after that date, any gain derived from the payment of the claim is taxable. The amount of such gain is the excess of the proceeds of the claim (both principal and interest) exclusive of any interest accrued since February 28, 1913, already returned as income, over the cost thereof (both principal and interest then accrued). However, the gain to be included in gross income where the fair market value of the claim as of March 1, 1913, is greater than the cost thereof, is the excess of the amount received over such value. No gain results where the amount received from the claim is more than the cost thereof but less than its fair market value as of March 1, 1913. In the case of an insurance policy its

[9] See Chapter XV.
[10] See Chapter XXX.
[11] See page 351 *et seq.*

surrender value as of March 1, 1913, may be used as a basis for the purpose of ascertaining the gain derived from the sale or other disposition of such property. Where services were rendered prior to March 1, 1913, but paid for thereafter, the amount received is taxable income to the extent of the excess of such amount over the fair market value on March 1, 1913, of the principal of the claim and any interest which had then accrued. . . . . (Art. 90.)

When a valid and valuable claim existed, it would not seem to make much difference whether the right was conditional or unconditional.

Ruling. A corporation obtained judgments against several companies on account of infringements of patent rights, certain of the infringements having occurred before March 1, 1913. The basis for the settlement of the judgments was a certain price per box of goods manufactured by the infringing companies established for each of the several years during which the infringements occurred.

Held, that the payments do not represent royalties but damages, and only so much thereof as exceeds the fair market value of the corporation's claims against the infringing companies on March 1, 1913, constitutes taxable income. Inasmuch as the corporation keeps its books upon an accrual basis, such damages must be returned for income tax purposes for the year in which the highest court rendered its decision, or if the case was not appealed, for the year in which the decision of the lower court was rendered. (C. B. I-1, page 111; Digest I. T. 1294.)

Definition of word "property."—In a hearing before the Hague Permanent Court of Arbitration, on August 3, 1922, Senator (now Justice) Sutherland agreed with the President of the Court that the word "property" has wide application and includes "rights to have things done."

Investment in non-taxable securities.—Many taxpayers are considering the relative advantages of investments in government and other non-taxable or partly taxable bonds as compared with investments in wholly taxable securities. This question arises both in the investment of income and in the change of investments held. Tables have been prepared by investment bankers and others which show the relative net return from taxable and non-taxable securities to recipients of income of different amounts. It is often possible for a

taxpayer to reduce his tax burden by investing in non-taxable securities, but it must be borne in mind that tables which show comparative returns can be prepared only with reference to assumed conditions of investments and income. Each individual's tax, however, depends on the sources of his particular income, whether from business activities, dividends, interest on bonds or other sources. Moreover, if changes in investments are made, there may be losses upon sales which materially affect the advantage of the changes. Consequently, a taxpayer who considers whether to invest in government bonds or other non-taxables should realize that not general information, but a study of his particular conditions of investments and income, is needed to determine what he would gain, as to taxes, by any investment. Particularly is this true in view of the possible, although improbable, further reduction in the upper brackets of the surtax.

Accounting procedure.—

LAW. Section 212[12] . . . . **(b) The net income shall be computed . . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer;[13] but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. . . .**

REGULATIONS. (1) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 200 of the statute for definitions of "paid," "paid or accrued," and "paid or incurred." [14] All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. . . . . For instance, in any case in which it is necessary to use an in-

[12] Section 232 makes section 212 applicable to corporations.

[13] The provision was the same in the 1918 law. For summary of the provisions of former laws regarding the "accrual" and "cash" bases, see *Income Tax Procedure*, 1918, pages 67-70.

[14] See page 400.

ventory, no accounting in regard to purchases and sales will correctly reflect income except an accrual method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. . . . . On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. . . . . (Art. 23.)

It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. . . . . Among the essentials are the following:

(1) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year. . . . .;

(2) Expenditures made during the year should be properly classified as between capital and income, that is to say, that expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and

(3) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion, or obsolescence any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses. . . . . (Art. 24.)

Period for which net income is computed.—

Regulations. Net income must be computed with respect to a fixed period. Usually that period is twelve months and is known as the taxable year.[15] . . . . The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. . . . . If the taxpayer does not regularly employ a

[15] Defined in section 200 (1). For a discussion of the period covered by returns, see page 76 *et seq.*

method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it. (Art. 22.)

Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. . . . . The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year. . . . . A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next or any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. Judgments or other binding adjudication, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduction, less any amount of such damages as may have been compensated for by insurance or otherwise. . . . . A loss from theft or embezzlement occurring in one year and discovered in another is ordinarily deductible for the year in which sustained. . . . .[16] (Art. 111.)

The foregoing article sets forth good accounting practice. It recognizes that the best test of an adjustment is its relation to the business as a whole. It also describes the proper method of procedure when a loss is discovered in a fiscal year succeeding the year in which it should have appeared as a deduction.

Income of railroads from earnings under federal control.—A railroad claimed that during 1918-1920 net earnings had been realized.[17] The railroad administration denied the claim. In 1920 a small payment in compromise

[16] The Treasury in a recent ruling held that "an amount ascertained to have been lost through embezzlement is allowable as a deduction from gross income for the year or years in which the funds were so converted, and that any sum recovered should be allocated to each year in which the funds were embezzled. . . . ." (I-42-548; I. T. 1470.) Also see Chapter XXXIV.

[17] I-42-549; I. T. 1471.

was made on account; in 1921 full settlement was made. Held that the amount received in 1921 was income for that year.

Cash or accrual method of computing net income.—

Law. Section 200. . . . . (4) The term "paid," for the purposes of the deductions and credits under this title, means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212. . . . . [18]

The foregoing provisions are much more positive in tone than the permissive clauses included in the 1916 law and have been interpreted by the regulations to require the accrual basis for tax purposes when that method is used in the accounts.

All well-conducted business concerns attempt to make their books reflect actual net income for their accounting periods. When this is done in good faith the income tax return should exactly agree with the books, subject to statutory provisions.

Individuals do not, as a rule, keep books, and when they do, their so-called accounts consist usually of cash records. But when reasonably accurate accounts are kept the taxpayer is more than repaid for the trouble involved. They assist economy and encourage thrift. Without accurate accounts an income tax cannot be satisfactorily assessed. The Commissioner would be justified in directing that every taxpayer be required to keep a clear record of gross income as it accrues and of expenses as they are incurred. (See T. D. 3408.)

Nothing can be more obvious than the proposition that true "net income" cannot be determined by looking over one's cash account. Even day-laborers, many of whom now receive taxable incomes, often do not receive their wages in the period in which they are earned. It is not intended to suggest that taxpayers of this class should be required to prepare a return on the accrual basis; but if the wage-earner, whose wages for December, 1922, amounting to $200, were not received

[18] Same in 1918 law.

by him until January, 1923, desires to include the $200 in his 1922 return, he should be encouraged to do so.

RULINGS. Under the income tax statutes taxpayers are required to render true and accurate returns of annual net income in manner and form prescribed by the Commissioner with the approval of the Secretary of the Treasury. Any return which in the judgment of the Commissioner does not reflect the true net income of a corporation may be rejected by him and the taxpayer required to render a return on such basis as he may prescribe. Therefore, the action of the Unit in requiring a corporation engaged in the mercantile business, which made its returns for 1917 and 1918, on the basis of receipts and disbursements, to file amended returns on the accrual basis was proper and is approved.

The general plan which has been adopted with respect to mercantile corporations of requiring that both inventories and accounts receivable shall enter into the computation of net income is proper and in accord with the law and regulations. (C. B. 3, page 76; Digest A. R. R. 217.)

In Wisconsin, the liability of a taxpayer to pay any part of the amount of State income tax assessed in one year against his income of the previous year is contingent upon the determination of the amount of personal property tax levied against him for the year following the year the income of which is taxed. The accrual of any State income tax is therefore not proper prior to the levy and assessment of the personal property tax. (C. B. I-1, page 123; Digest I. T. 1272.)

An individual from whom tax was withheld during 1921 by his employer for the purpose of the New York State personal income tax, which tax was not paid till 1922, may deduct from the gross income reported in his Federal income tax return for 1921 the amount of such withheld tax, whether his accounts were kept on the accrual basis or on the basis of cash receipts and disbursements. (C. B. I-1, page 125; Digest I. T. 1273.)

A partnership, which keeps its books on an accrual basis, is required to pay to an injured employee a sum in weekly installments extending over a period of several years, such sum being fixed by the industrial commission of the State wherein the partnership is located.

It is held, that the entire amount of the compensation award made by the industrial commission of the State may be deducted in the taxable year in which the award was made, as the award became an accrued liability at that time. (O. D. 686, C. B. 3, page 148; O. D. 992, C. B. 5, page 118; and O. D. 1123, C. B. 5, page 133; revoked.) (C. B. I-1, page 123; Digest I. T. 1263.)

The three rulings revoked held that the instalments only, as paid, were deductible and not the full amount of the award in the year made.

In a case dealing with a law partnership, where an attempt had been made to accrue fees from professional services, it was held:

Ruling. . . . . Numerous court decisions have been cited by the appellant in support of its contention that the rendition of a bill by a lawyer does not constitute a binding account receivable until the amount has been assented to by a client. It was further argued that the charges for legal services entered on its books were not determinable, and did not constitute income in the sense contemplated by the income tax laws. Further, that the charges were not "accounts receivable" as usually understood for the reason that no agreement existed between the principals fixing the amount of compensation for the services rendered.

In view of the foregoing facts the Committee is of the opinion that the method used by the appellant in determining its net income for the taxable year 1920 is not sufficiently definite to be construed as clearly reflecting the income of the firm, that the method used is not an accrual method in its acknowledged sense, and that the computation of net income for the year 1920 is more correctly determinable on the basis of cash receipts and disbursements. Further, that this conclusion is fully warranted under the provisions of section 212, Revenue Act of 1918, which empowers the Commissioner to make the computation on the basis and in such manner as in his opinion does clearly reflect the income.

It is therefore recommended, in the appeal of the M partnership that the action of the Income Tax Unit in denying permission to change from an accrual to a cash receipts basis in computing the net income of the firm for the taxable year 1920 be reversed and the appeal accordingly sustained. (C. B. I-1, page 47; A. R. R. 702.)

Changing from cash to accrual method.—If a taxpayer who has kept his books on a cash basis desires to change to an accrual basis, he must first secure the consent of the Commissioner. It is most improper to change more than once unless the reasons are extremely cogent.[19]

In the long run the government is not likely to gain or lose anything by permitting one change, but if shifting back and

[19] T. D. 2433 (January 8, 1917).

forth were freely permitted wholesale evasion might easily result.

It is desirable for the taxpayer who contemplates a change in his method of reporting, to restate his accounts as of the beginning of the taxable year as well as at the end, and thus put all the current year's earnings and expenses on an accrual basis.

REGULATION. . . . . (3) A taxpayer who changes the method of accounting employed in keeping his books for the taxable year 1921 or thereafter should, before computing his income upon such new basis for purposes of taxation, secure the consent of the Commissioner. Application for permission to change the basis of the return shall be made at least 30 days before the close of the period to be covered by the return and shall be accompanied by a statement specifying the classes of items differently treated under the two systems and specifying all amounts which would be duplicated or entirely omitted as a result of the proposed change. . . . . (Art. 23.)

RULINGS. Office Decision 481, ruling 18-20-893, modified by Office Decision 636, ruling 34-20-1144, is further modified so as to provide that where a farmer keeping his accounts on the cash receipts and disbursements basis desires to change to the accrual basis, and actual records or definite proofs are submitted which establish to the satisfaction of the Commissioner of Internal Revenue the existence of an animal or other production asset on a date previous to any date on which the farmer has paid income tax, inventory adjustments may be made in accordance with the instructions contained on page 4 of Form 1040-F. (C. B. 3, page 81; O. D. 685.)

A taxpayer, having reported his income prior to 1920 on the basis of cash receipts and disbursements, is not permitted to change from that basis because the books in his publishing business are now kept on an accrual basis, his accounts showing his income from a partnership being still kept on the cash basis and no formal books of account being kept to show his income from miscellaneous sources. (C. B. 5, page 67; Digest O. D. 977.)

A taxpayer who had heretofore computed his income and filed his returns on the accrual basis changed his method of accounting to the cash receipts and disbursements basis on June 30, 1921, the close of his taxable year, and applied to the Commissioner for permission to compute his income in his return for the 1921 fiscal year on the cash basis.

Held, that inasmuch as the change in his method of accounting was not made until the close of the taxable year, permission to com-

pute income in his return for 1921 on the cash receipts and disbursements basis is denied. (C. B. 5, page 79; O. D. 1113.)

A taxpayer who has properly filed his return on the cash receipts and disbursements basis can not be granted permission to amend it by stating that it is filed on an accrual basis, even though his cash receipts and disbursements were the same as his accrued income and deductions except as to the item taxes accrued to a foreign country. (C. B. 5, page 79; O. D. 1133.)

A corporation making sales on the installment plan which made returns for the years 1917 to 1920, inclusive, on the basis of treating the sales as cash transactions, in accordance with the method of accounting employed in keeping its books of account, will not be permitted to file amended returns for those years reporting on the basis of the proportionate part of each installment received representing profit.[20] (C. B. I-1, page 49; I. T. 1190.)

A taxpayer, acting in the capacity of a cotton factor, who prior to 1920 accrued interest on its books by charging the accounts of cotton shippers with interest on debit balances, is denied the right to omit from its income-tax return for 1920 interest items of this character standing accrued on its books at the close of the taxable year 1920, although, because of the fall in the value of cotton, there was every reasonable expectancy that the interest could not be collected or realized upon.[21] (C. B. I-1, page 15; A. R. R. 737.)

The 1921 law continues the provision of the 1918 law which gave the Commissioner power to require inventories "whenever necessary clearly to determine the income of any taxpayer" and specified that the basis should "conform as nearly as may be to the best accounting practice in the trade or business."[22]

Fortunately, the determination of the "best accounting practice" is not difficult. Briefly defined, the term means accounts and methods which correctly reflect the true financial position of a concern as to net worth and earnings and thus make it possible to secure information which will prevent the proprietors or executives from deceiving themselves.

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[20] For full discussion of instalment basis of reporting, see Chapter XX.

[21] The uncollectible interest was allowed as a bad debt, however. See Chapter XXXV.

[22] Section 203.

It is very gratifying to note the recognition given in recent laws to good accounting practice. It does not diminish the government's revenue and it enables taxpayers to prepare returns readily from accounts which accurately reflect true net income.

The subject of inventories is fully discussed in Chapter XIX.

The Commissioner has no authority to refuse permission to use the inventory method when its use (rather than the cash basis) more clearly reflects the annual income of the taxpayer.

"CONSTRUCTIVE" RECEIPT.—Even when the cash basis is used, the regulations provide that income must be reported when it is made available "without substantial limitation or restriction," irrespective of whether or not it is actually reduced to possession. If an item is a "constructive" receipt it is taxable.

The following regulations cover this matter fully.

REGULATIONS. Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made. A book entry, if made, should indicate an absolute transfer from one account to another. If the income is not credited, but is set apart, such income must be unqualifiedly subject to the demand of the taxpayer. Where a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt. (Art. 52.)

Where interest coupons have matured and are payable, but have not been cashed, such interest payment, though not collected when due and payable, is nevertheless available to the taxpayer and should therefore be included in his gross income for the year during which the coupons matured. This is true if the coupons are exchanged for other property instead of eventually being cashed. Defaulted coupons are income for the year in which paid. Dividends on corporate stock are subject to tax when unqualifiedly made subject to the de-

mand of the stockholder,[23] . . . . The distributive share of the profits of a partner in a partnership is regarded as received[24] by him although not distributed. . . . . Interest credited on savings bank deposits, even though the bank nominally have a rule, seldom or never enforced, that it may require so many days' notice in advance of cashing depositors' checks, is income to the depositor when credited. . . . . (Art. 53.)

RULINGS. Under the by-laws of a cooperative bank the profits credited to a shareholder may not be withdrawn in their entirety until five years have elapsed, but three-fourths of such profits may be withdrawn at any time upon 30 days notice, in which case the other fourth is forfeited.

The question presented is whether the profits credited to a shareholder of the bank are credited to or set apart for him without restriction, and, if so, whether the net amount which he might immediately withdraw or the whole amount credited to him should be reported as income.

Held, that three-fourths of the profits credited to the shareholder are credited to or set apart for him without restriction, and as such should be included in gross income for the year in which so credited or set apart. The remaining one-fourth becomes income, constructively received, at the end of the five-year period, provided he has not previously withdrawn his shares. (C. B. 5, page 99; O. D. 1081.)

The donation by assignment of partnership profits to be earned in the future does not exempt such profits, when determined, from taxation as a part of the individual income of the donor. (C. B. 1, page 80; Digest O. 912.)

Where an individual is employed as an agent for a firm and under his contract is to receive as compensation 50 per cent of the profits of the agency which may be appropriated by him monthly as earned, the amount actually appropriated constitutes income of the agent for the year in which appropriated. (C. B. 2, page 64; Digest S. 1312.)

A distinction was drawn in this case between profits "credited or set apart" and profits "appropriated" by the individual who was entitled to draw against his share of profits. On this point the detailed opinion states:

RULING. Attorneys for the claimant make the contention that the claimant's portion of the monthly profits of the agency constitute income of the claimant each month; that is to say, the claimant's share

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[23] See Chapter XXIX. This phrase in the earlier regulations read "set apart for."

[24] See Chapter XXIX.

of the profits are received by him during the month in which earned. This contention is based upon the ruling of this office contained in article 53 of regulations 45, the wording of which is "income which may be drawn at any time is subject to the tax for the year during which so credited or set apart, although not then actually reduced to possession." This contention is not valid for the reason that the profits of the agency are not credited to him or set apart month by month. The contract of employment provides that such profits "shall be and are the property of M."

This ruling is not convincing. It seems that an agent who is entitled to 50 per cent of the profits of a business should be required to report all of the earnings which accrued to him during each period rather than the amount "appropriated." If he had not "appropriated" any part of the earnings it is hardly likely that the Treasury would have permitted him to say that he had no taxable income.

RULINGS. Held, that commissions duly authorized and credited as compensation for services, when under control of the creditor and subject to his draft, should be treated as taxable income for the year in which credited, even though not reduced to possession in that taxable year. (C. B. 4, page 100; Digest A. R. R. 366.)

Stockholders of a corporation were advised of the decision of the board of directors to distribute a portion of the assets, the distribution to be made as of December —, 1915, and they were given until January —, 1916, to elect whether they would receive stock or cash.

Held, that there could be no constructive receipt until the option was exercised by the stockholders and communicated to the corporation. . . . . (C. B. 4, page 102; Digest A. R. R. 375.)

An amount received by the lessee from the lessor of a living apartment, upon the termination of the lease, before its expiration for the purpose of defraying storage charges upon the lessee's household goods, should be included in gross income. (C. B. 5, page 81; Digest A. R. R. 617.)

The foregoing ruling is not sound. If the tenant had remained until the expiration of his lease there would have been no storage charges. The tenant was merely reimbursed for an expense incurred for the account of another. There is no legal or accounting precedent for calling such a receipt constructive income.

Book entries.—It is desirable, from many points of view, that income tax returns should agree with the books of the taxpayer; but the entries made on the books are not of fundamental importance when compared with the actual facts in a given situation.[25] The facts, not the book entries, control.[26]

Community property.—The author discussed the subject of community property at some length in *Income Tax Procedure,* 1922, page 395 *et seq.* The reader should refer to the discussion therein contained. During 1922 rulings on community property have been issued as follows:

Rulings. The community income of a husband and wife, American citizens but residents of the Philippine Islands, is returnable in its entirety by the husband. The community income comprehends not only that derived from community property but also the earnings of the wife and the income from her separate property.[27] (C. B. I-1, page 235; Digest I. T. 1297.)

In 1919 A sold a piece of real estate in Texas at a sum greater than the value thereof on the date of its acquisition and the profit so realized was returned as community income. The property was purchased by the husband of A in the year 1915 from his individual earnings and he had the deed made to her as her separate estate.

Inquiry is made as to whether such income was properly reported.

. . . .

If the real estate in question was conveyed to A as her separate estate, whether so expressed in the deed or so understood and intended by the husband and wife, it of necessity follows that the gain realized upon the sale was not income of the marital community but the separate income of the wife. Amended returns for 1919 should be filed by A and her husband, in which the gain derived from the sale of the property in question is reported in accordance with the foregoing. (C. B. I-1, page 236; I. T. 1321.)

Under the laws of the State of Washington the profit derived from the joint operation of a farm by a husband and wife, the farm

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[25] See Reg. 45, Art. 23, and T. D. 2873.

[26] Book entries, however, were required by the 1918 and earlier laws if deductions were claimed for bad debts. In the cases of both individuals and corporations, debts to be deductible must have been "ascertained to be worthless and charged off." [1918 law, section 214 (a-7).]

[27] The basis of this ruling is a decision of the Supreme Court of the Philippine Islands, rendered in 1918; *Madrigal v. Rafferty, Collector,* 38 Phil. 414.

being the separate property of the former, constitutes separate income of the husband. (C. B. I-1, page 232; Digest I. T. 1235.)

The income realized from the sale of property in Nebraska (not a community property State) acquired by a husband and wife while domiciled in that State and sold after removing to Idaho is not community income divisible between husband and wife for income tax purposes. (C. B. I-1, page 234; Digest I. T. 1236.)

Whether real estate located in the State of Oregon, which was acquired with the joint earnings of husband and wife, who were domiciled in the State of Washington, is divisible as separate or community property is dependent upon the laws of Oregon, since the community property laws of one State do not operate on the real property of another State. Under the laws of Oregon, if title to the land stands in the name of both husband and wife, then by virtue of their joint tenancy or tenancy in common, as the case may be, the income is divisible between them for income tax purposes. If title to the land stands in the name of the husband or wife and there has been no agreement expressed or implied by which the other spouse has relinquished his or her interest in the community fund with which the land was purchased, or in the land itself, the husband or wife in whose name the land stands will be considered to hold the land in trust for the other, to the extent of the latter's interest in the money invested in the purchase, in which case the income therefrom is divisible between them for income tax purposes by virtue of the trust. (C. B. I-1, page 234; Digest I. T. 1268.)

. . . . It appears that A and B at the time of their marriage entered into an agreement that each should have an undivided one-half interest in all the property, real and personal, then owned by either, or thereafter to be acquired. It does not appear whether this agreement was written or oral, but it is to be inferred, from the fact that a writing was executed in 1917 affirming it, that it was by parol.

. . . .

In view of the foregoing the Committee recommends that the action of the Income Tax Unit in holding that the parol agreement entered into between A and B at the time of their marriage, which agreement was reduced to writing in——, 1917, did not create such a community of interest as will permit each of such persons to return for Federal income-tax purposes as his or her personal income one-half of the aggregate net income of both, be sustained; and that it be held that for the years 1917, 1918, and 1919 the income derived by A from his property and personal activities is his separate property and must be returned by him and the income of B from her property and personal activities is her separate property and must be returned by her, unless the parties file a joint return as husband and wife. . . . . (C. B. I-1, page 225; A. R. R. 755.)

A, an American citizen born in France, married B, an American citizen in France. A, previous to his marriage, and he and his wife subsequently thereto, resided continuously in France. In his will and several codicils he recognized that he was married under the French community of goods system. A died in 1919 a resident of France.

The matrimonial domicile of A and his wife was at all times in France and the French law is applicable to the case.

Under the French Civil Code the income of A and B is community income, and the income received in 1919 prior to A's death may be divided equally between them in reporting their gross income in their tax returns. (I-32-450; Digest I. T. 1414.)

A citizen resident of Cuba who pays taxes on income earned in the United States claimed that the Cuban law is "virtually and practically the same as the community property law existing in Texas." The Treasury has held that the law of Cuba in this respect is the same as that of Spain, and is not similar to that of Texas, and that the income must be reported in its entirety by the husband. (I-43-562; I. T. 1479.)

The problems connected with the filing of returns in community property cases, including the problem of amended returns for previous years, are discussed in Chapter V, and in *Income Tax Procedure,* 1922, page 395 *et seq.*

CHAPTER XVII

INCOME FROM PERSONAL SERVICES

Following the plan of subdividing the items of income into convenient groups, and adopting generally the order and classification used in the statute, this chapter is devoted to income from personal services. This term includes not only salaries and wages, but also fees received from professions or vocations.

LAW. Section 213. . . . . **(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations,[1] . . . .**

Accounting Procedure

Receipt or accrual method.—Salaries and wages need not be accounted for in the return until payment is made and received.[2] Unquestionably this is the most convenient method of dealing with salaries and wages, because comparatively few recipients of incomes of this nature keep books, and it would require some adjustments of accounts to report the

[1] [Former Procedure] In 1917, those who received incomes in the form of salaries, compensation for services, including all professional fees, commissions, and income in general from an occupation, vocation, profession or from a business with no capital or only nominal capital were compelled to pay, in addition to their income tax, a tax of 8 per cent upon the income from such sources. In other words, if anyone received an earned income of any kind in excess of $6,000 which had not been subject to the excess profits tax, he was subject to this 8 per cent tax. The language of the 1917 law is the same as the 1913 law except for an immaterial change in the first phrase of section 4. No tax of this kind appears in the 1918 or 1921 laws.

[2] See Chapter XXXI as to deductions of compensation for personal services in carrying on a trade or business.

salary earned within a calendar year but partly paid prior or subsequent thereto. But anyone desiring to keep books on an accrual basis (that is, entering all income as earned and all expenses as incurred) is permitted and encouraged to do so. For a full discussion of the accrual method, see page 400. If any part of the accrued income so reported becomes uncollectible, the regulations permit credit to be taken therefor as an allowable deduction.

The so-called receipt method cannot be used if it serves to obscure the taxpayer's actual net income for the taxable period. Section 212 (b) defines "net income" and states that "if the method [of accounting] employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income."

If the taxpayer prefers to prepare his income tax return from his cheque book or cash book, no fault will be found, if the result clearly reflects his actual net income. In such cases, if the taxpayer's income arises from fees, etc., it is suggested that a cash book with several columns would be most useful. On the receipt side all items of receipts from fees, etc., should be entered in a column reserved for the particular purpose, so that at the end of the year the aggregate of such column will be the proper amount to include in the return. If at all feasible, however, the accrual system should be adopted. No other method accurately reflects net income, except in the case of wage-earners who have no investments.

Regulation. Where no determination of compensation is had until the completion of the services, the amount received is ordinarily income for the taxable year of its determination, if the return is rendered on the accrual basis; or, for the taxable year in which received, if the return is rendered on a receipts and disbursements basis. . . . . (Art. 32.)

Many professional men, when closing their books for their taxable year, enter as accrued income an estimate of what has been earned to such date, and report such estimate as taxable income. This they have a right to do under the law.

RULING. A taxpayer who keeps no books of account, and to whom is paid, upon the termination of services extending over a period of years, a lump sum in amount not previously agreed upon, as compensation for such services, must return as income in the year in which received the entire amount so paid him, even when such payment is accompanied by a statement proportioning the compensation over the years in which the services were rendered. . . . . (C. B. 2, page 80; T. D. 2960.)[3]

In the foregoing case the service did not begin until May 27, 1913.

The following court decision is also of interest.[4]

DECISION. (Syl.). . . . . Where, relying on the unofficial promises of a majority of the board of directors that additional salary would be voted him for past years, the president of a corporation overdrew his account with the corporation, additional salary, subsequently voted, was income to him for the year in which the amount thereof was finally settled upon and segregated by an order of the board, although he had actually received and spent the money, as overdrafts, prior to that year.

This procedure, as well as the principle laid down in the *Jackson* case,[5] works an injustic to the taxpayer.

If the Supreme Court adopts the principle that income cannot be taxed unless and until it is realized in cash, or the equivalent of cash, the Treasury will have to recede from its position in Regulations 45 and many rulings. Its former principles, however, regarding uncertain and undetermined claims, resulting in realizations in later years, have been overruled in Regulations 62.[6]

"BACK PAY" AWARDED BY RAILROAD BOARD TAXABLE IN YEAR OF RECEIPT.—

RULING. A taxpayer who had been discharged from the employ of a railroad company was reinstated by order of the Railroad Board and paid for all time lost during a period of over two years.

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[3] This statement was issued with an extract of the decision in the case of *Jackson v. Smietanka,* 267 Fed. 932. The Circuit Court of Appeals for the Seventh Circuit has recently affirmed this decision (272 Fed. 970).

[4] *Holbrook v. Moore,* United States District Court, February 8, 1921 (not reported). See T. D. 3161.

[5] *Jackson v. Smietanka, supra.*

[6] See Art. 51.

It is contended that the sum received by the taxpayer, for which he rendered no service, is in reality a gift and not taxable.

Held, that the payment can not be treated as a gift for the reason that it was not made voluntarily. It is income within the ordinary acceptation of the word and not being such income as is expressly exempt under the Act, should be included in the return of the taxpayer for the year in which it was received by him. (C. B. 2, page 71; O. D. 512.)

Compensation of trustee taxable when received.—

RULING. If no determination was made as to the amount due the trustee of an estate as compensation for his services over a period of years until the trust was terminated, the amount allowed him should be returned in full, subject to allowable deductions, as income for the year in which paid; and should not be prorated over the length of time during which he served as trustee. (T. D. 2135, January 23, 1915.)[7]

The question here arises as to what constitutes a "determination." This ruling, of course, would not be applicable if it could be shown that a definite, or an approximately definite, portion of the fee had been earned and had accrued prior to March 1, 1913. The trustee could not legally be taxed on income which accrued prior to the date when the law went into effect.[8]

Otherwise the ruling is fair, because the trustee could have reported the accruing income annually. If he did not do so and was compelled to return a large amount in a year when there was in force a tax rate higher than during the years when the income accrued, he had only himself to blame for not having adopted the accrual basis.

Compensation for services rendered before March 1, 1913—How far taxable.—

REGULATION. . . . . Where services were rendered prior to March 1, 1913, but paid for thereafter, the amount received is taxable income to the extent of the excess of such amount over the fair market value on March 1, 1913, of the principal of the claim and any interest which had then accrued. . . . . (Art. 90.)

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[7] See also C. B. 1, page 68; T. B. R. 12.
[8] See Art. 90.

This is logical. The accrual before March 1, 1913, was not taxable, because in effect it became capital at that date. If it was found to be bad after that date, it was properly an allowable deduction. If the income accrued after March 1, 1913, and was not returned for taxation, it would be improper to claim the loss as a deduction.

Compensation of certain federal and state officers.—In general, the salaries of federal officials are taxable.

Regulation. . . . . The salaries of Federal officers and employees are subject to tax, except that, in view of the provisions of the Constitution of the United States as construed by the Supreme Court, the salaries of the President of the United States and Federal judges are not subject to a new tax or an increased tax if elected or appointed to office prior to the passage of the taxing statute. The Revenue Act of 1921, however, imposes no new or increased tax upon such salaries; hence the salaries of all Federal judges appointed since February 24, 1919, are subject to the tax imposed by the Revenue Act of 1921. . . . . (Art. 32.)

For a discussion of whether the salary of the President and judges is taxable, see Chapter XV.

Salaries of state officers and employees.—The present attitude of the Treasury is to tax payments made by states to those who do not come within the classification of officers or employees.

Definition of "officer" and "employee."—

Rulings. An officer is a person who occupies a position in the service of the Government, the tenure of which is continuous and not temporary, and the duties of which are established by law or regulations and not by agreement.

An employee is one whose duties consist in the rendition of prescribed services and not the accomplishment of specific objects, and whose services are continuous, not occasional or temporary. (C. B. 5, page 107; Digest A. R. R. 664; Sol. Op. 122.)

Where persons are appointed pursuant to a city ordinance to perform services as real estate and building experts subject to the direction of a board charged with the duty of originating schemes for local improvements, to be paid for in whole or in part by special assessments or taxation, and with the duty of directing condemnation pro-

ceedings, which board retains and exercises the power to control the manner and means of performance of the duties of the persons employed, such employment to be continuous and exclusive of all other employment, the compensation received is not subject to Federal income tax even though it is fixed upon the basis of a percentage of the value of the property with which the experts are to deal. When such conditions obtain, with the exception of the requirement that the time of the persons employed must be exclusively devoted to such work, the mere fact that this requirement is absent does not change the nature of the relationship.

Where, however, persons employed by municipal or State agencies are to furnish a completed work and control of the manner and means of performance of such work is not retained by the appointing authority, amounts received in payment are not exempt from Federal income tax as compensation paid a State employee. (I-40-535; Sol. Op. 145.)

The compensation of the following has been held to be taxable:

Administrators. (C. B. 1, page 96; O. D. 256.)
Appraisers appointed by state court. (C. B. I-1, page 104; I. T. 1305.)
Assistants to clerks of state courts—naturalization duties. (C. B. 2, page 99; O. D. 484.)
Bank designated as state depository. (C. B. 5, page 113; O. D. 1090.)
Confederate state pensions. (C. B. 4, page 112; O. D. 903.)
Executors. (C. B. 1, page 96; O. D. 256.)
Firm of civil engineers having contract with irrigation district of a state. (C. B. 2, page 100; O. D. 545.)
Individuals constructing a causeway. (C. B. 2, page 101; O. D. 553.)
Liquidating trustee. (C. B. 2, page 98; O. D. 369.)
Pilots employed by state commission. (C. B. 4, page 112; O. D. 916.)
Public library employees. (C. B. 5, page 106; O. D. 973.)
School officers appointed without statutory authority. (C. B. 2, page 98; O. D. 449.)
Special counsel to city. (Letter to Collins and Corbin, signed by J. H. Callan, April 15, 1919.)
Surgeon paid by state industrial commission. (C. B. 5, page 106; O. D. 1038.)
Teachers employed by institution not wholly owned by state. (C. B. 1, page 93; O. 826 and C. B. 5, page 105; O. D. 963.)
Witnesses summoned by state attorney. (C. B. 1, page 67; O. D. 195.)

Contractor for public work not a public employee.—

REGULATION. Any profit received from a State or political subdivision thereof by an independent contractor is taxable income. Where warrants are issued by a city, town, or other political subdivision of a State, and are accepted by the contractor in payment for public work done, the fair market value of such warrants should be returned as income. If for any reason the contractor upon conversion of the warrants into cash does not receive and can not recover the full value of the warrants so returned, he may allowably deduct from gross income for the year in which the warrants are converted into cash any loss sustained, and if he realizes more than the value of the warrants so returned he should include such amount in his gross income of the year in which realized. (Art. 37.)

If a contractor accepts payment in warrants which are selling in the market at less than par he need not account for the amount received at any value above the market. If the contractor retains the warrants and collects them from the municipality at par he will be accountable for the excess of par over the fair market value at time of receipt of the warrants. If sold for more or less than their market value when received, adjustment would have to be made at time of sale.

Salaries of civil service employees of the United States.—

RULINGS. . . . . The amounts deducted and withheld from the basic salary, pay, or compensation paid to employees in the civil service of the United States, in accordance with the provisions of the Act approved May 22, 1920, should be reported by such employees for income tax purposes. The total compensation of the employees should be reported in gross income and no corresponding deduction can be taken for the amounts withheld, inasmuch as such amounts are payments made toward the purchase of annuities provided for in the Act and are not allowable deductions for income tax purposes.

The annuities paid to retired employees are subject to tax to the extent that the aggregate amount of the payments exceeds the amounts withheld from the compensation of the employees. (C. B. 4, page 76; T. D. 3112.)

If an employee leaves the civil service of the United States before he is eligible to retirement under the Act of May 22, 1920, and receives the amount of salary withheld, together with interest, he should report only the amount of interest received by him as income for the year in which received. (C. B. 4, page 77; O. D. 823.)

Compensation for Services Distinguished from Gifts, Dividends, etc.

The establishment of a clear distinction between compensation for personal services, on the one hand, and gifts, distributions of profits or assets and payments for property, on the other, is one of the very difficult tasks in income tax procedure. In the case of bonuses, Christmas gifts, "profit-sharing" distributions, and other payments of a like nature, it is sometimes almost impossible to determine the exact extent to which they contain other elements than that of mere remuneration for services rendered. The Treasury has faced this problem squarely[9] and has issued regulations laying down the principles in accordance with which these distinctions are to be made. These regulations (articles 105-107) are quoted in full in Chapter XXXI.

Briefly it is held that "the test . . . . is whether they are reasonable and are in fact payments purely for services." Even though the payment is determined on a contingent basis and is greater than the amount which would ordinarily be paid, it may still be considered pure compensation if the basis is determined "pursuant to a free bargain between the enterprise and the individual made before the services are rendered . . . ." In case of compensation determined after services have been rendered, reasonableness is ordinarily the controlling test.[10]

The Treasury held, in the following case, that the payments made were for services which had been rendered and were not a gift:

Ruling. A was an employee of the M Company under contract for a period of 21 years, such contract being terminable at the will of the company. The company sold its assets and discontinued business during 1920, and at the time A's employment ceased in 1921 he received 6y dollars from the M Company as an expression of its appre-

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[9] The subject was first treated in a very inadequate fashion in Reg. 33, 1918, Art. 138. In T. D. 2696 (April 10, 1918) the subject was clearly and accurately presented.

[10] See Chapter XXXI.

ciation of his long and faithful service. A had no interest in the company, received nothing in the way of bonuses or extra commission, and had no agreement with the company for anything further than his salary.

This office has held that pensions and bonuses are in the nature of additional compensation to the recipient and must be included in computing net income. In a like manner, any lump sum received by an employee from a former employer upon the termination of his employment has in it a large element of compensation for services previously rendered.

It is held, therefore, that the amount received by A is in the nature of additional compensation and must be included by A in computing his net income for the year in which it was received. (C. B. 5, page 85; O. D. 1029.)

In cases such as the above, the assumption is that the payments are for services, but if intended as a gift the recipient is not taxable thereon. The facts of the foregoing case are not stated in detail, but it appears that the payment was made as an expression of the company's appreciation of the employee's long and faithful service. There would appear to be strong evidence to support a gift.

The following arrangement was held to constitute a gift:

Ruling. Subsequent to February 28, 1913, the M Company issued to A an endowment life insurance policy on his life. A made a single payment of $5x$ dollars in consideration of which the M Company agreed to pay as an endowment the sum of $6x$ dollars. The insured placed the policy on the accelerative endowment plan so that the policy became payable in 1920. It was agreed when the policy was written that the proceeds should be paid in two hundred and forty monthly payments, one-half of which should be paid to B, a son of the insured, and the remaining one-half to C, a daughter of the insured, provisions being made for payment in the event of the death of the beneficiaries named. The installments beginning with the —— were to be increased by such dividends as might be apportioned thereto. A is still living.

Held, that the endowment policy in question was a gift by A to B and C and that that part of each installment paid under the policy to B and C which represents a return of the capital value received by them, that is, the cost of the policy to the donor, is not taxable income, but that that part of each installment which represents the gain derived by them or dividends apportioned to the installment, should be returned as taxable income. (C. B. 5, page 92; O. D. 1108.)

Gifts or bonuses to employees.—The interest of the recipient of a bonus or similar kind of income is centered upon the taxes which he may properly be called upon to pay on account of the item. If it is adjudged an expense, he is fully taxable upon the amount received, because the employer has not paid any tax on the sum. Certain employers, however, prefer to make these payments tax-free to the recipients and to treat them as distributions of profits. In some cases such payments were made in good faith and charged as expenses, only to be subsequently disallowed by income tax inspectors. Naturally the recipients, in reporting the amounts received, should not have had to pay again the tax which had been paid in their behalf.

Article 107 prescribes in detail the procedure to be followed by the recipient of such income.

Commissions, fees and tips are taxable.—

REGULATION. . . . . Commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, ... are income to the recipients; as are also marriage fees, baptismal offerings, sums paid for saying masses for the dead, and other contributions received by a clergyman, evangelist or religious worker for services rendered. . . . . (Art. 32.)

Christmas gifts, however, are not considered income within the meaning of the law and are not supposed to be included in a return,[11] but if deducted by employers as additional compensation (as is usually the case) the amounts received are taxable.

RULING. Commissions advanced in payment for services of an advertising solicitor should be reported as gross income for the taxable year in which received. Any portion of the commissions thus received, which are paid back, owing to failure of payment for advertising, may be deducted as a loss for the year in which payments are returned. (C. B. 1, page 67; O. D. 19.)

The question arises as to the year in which a bonus should be reported. It is customary for many concerns to set

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[11] T. D. 2090 (December 14, 1914).

apart bonuses at the end of the year and pay them a few days after the close of the year.

RULING. In accordance with its annual practice, a company on December 31, 1916, set aside on its books a lump sum representing a part of its net profits for 1916 for the purpose of distributing the same to its employees as additional compensation for services rendered during that year. The actual disbursement of this fund was made on January 2, 1917.

Held, that this additional compensation was taxable in the hands of the recipient employees at 1917 rates, since the setting aside of the amount to be distributed on the company's books on December 31, 1916, was not a sufficient compliance with the regulations to warrant treating it as income constructively received in 1916. (C. B. 3, page 111; A. R. R. 182.)[12]

The Treasury also said in this case that "the amount set apart" was not subject to demand by the employees, and therefore in effect the bonus could not be said to be "constructively" received in 1916.

Compensation of the clergy.—

The Treasury has held that a pension paid to a retired clergyman is taxable income.

RULING. The fact that the pensions are paid through the governing body instead of by each individual church direct to the pensioners is immaterial, as the churches and the governing body are part of the same religious organization and the fund out of which the pensions are paid is contributed by the churches by whom the retired clergymen were formerly employed. (C. B. I-1, page 69; I. T. 1157.)

RULING. A clergyman is not liable for any income tax on the amount received by him during the year from the parish of which he is in charge, provided that he turns over to the religious order of which he is a member, all the money received in excess of his actual living expenses, on account of the vow of poverty which he has taken.

Members of religious orders are subject to tax upon taxable income, if any, received by them individually, but are not subject to tax on income received by them merely as agents of the orders of which they are members. (C. B. 1, page 82; O. D. 119.)

The rental value of a house furnished to a minister of the gospel is not included in taxable income.[13]

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[12] Issued under Revenue Act of 1917.
[13] Section 213 (b-11).

Should taxes be eliminated from profits in computing bonus?—In calculating the amount of tax to be paid by recipients of commissions, bonuses, etc., which are based upon the profits of a business or a department thereof, the question arises as to the obligation, if any, of such recipients to assume a share of the tax paid by the business. Payments of such commissions, etc., are expenses of the business and should be treated as such by deducting them from gross income before stating the net profits subject to excess profits and income taxes. It follows, therefore, that since the payments referred to are reported as allowable deductions, no tax of any kind has been paid thereon by the business, but the recipients must personally pay income taxes[14] on any amounts they may receive, subject, of course, to statutory exemptions, other income, etc. Obviously, then, in the absence of any specific agreement to the contrary, it would be unfair to the recipients to compute such commissions, etc., on the income of the business after deducting income and excess profits taxes.[15]

This position is subject to modification in cases where there may be said to exist an understanding with an employee that federal income and excess profits taxes are to be deducted before ascertaining the amount available for distribution to an employee who is on a profit-sharing basis and to the partners or stockholders. If an employee were on a salary basis the full amount of the salary, no matter how large, would be paid to the employee without deduction for federal taxes. Many employees who change from a salary to a so-called profit-sharing basis contend that, as they are held responsible for their income taxes (and in 1917 for the 8 per

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[14] [Former Procedure] For any part of the year 1917, the 8 per cent excess tax had also to be paid.

[15] Decision *Edgar W. S. Reeder v. G. Winthrop Coffin and Quincy A. Gillmore,* individually and as copartners, trading as Coffin & Gillmore, Court of Common Pleas No. 3 (Philadelphia), June Term, 1918, No. 3268 (not reported). Extract from opinion: McMichael, P. J., November 15, 1918.

"We have considered the question of deduction of income taxes before allowing the plaintiff 5 per cent of the net profits as salary. We do not think this deduction should be made, as it is not in any way contemplated by the contract."

cent excess profits tax), employers have no right to transfer to them any part of a burden which fortuitously has been laid solely or chiefly upon the employer. In claiming the amount paid to the employee as a deductible business expense, the employer may be said to assent to the position that the employee is not liable to a tax based on net income. In view of the very high income and other taxes imposed upon corporations in the years prior to 1922, the whole matter becomes one of expediency. Employers and employees should come to an understanding and amend existing contracts by adding a clause setting forth the agreement which may be reached. In any event it is incorrect to calculate the taxes which would be payable if the employee had no interest in the business, and then charge the employee with a proportion of such amount equal to the percentage of profits to which he is entitled. This method is sometimes followed, but it imposes upon the employee part of a tax which is not paid to the government.

If it is decided that the employee is to bear a proportionate share of federal taxes on the net income remaining after his compensation has been charged as an expense, it will be necessary to use a somewhat complicated formula for determining the amount of net income remaining after deducting from earnings the compensation due to the employee; because the compensation due cannot be determined until taxes are allowed for—and taxes cannot be allowed for until the compensation due to the employee is determined.[16]

Compensation "of Whatever Kind and in Whatever Form Paid"

The law specifies that compensation for personal services shall be reported as income even if received in some form other than cash. Taxable income is to include compensation "of whatever kind and in whatever form paid." The regula-

[16] For illustrations setting forth as simple a formula as can be devised for reaching the desired result, see *Income Tax Procedure*, 1922, pp. 424-430.

tions governing the valuation of services not paid for in cash read as follows:

REGULATION. Where services are paid for with something other than money, the fair market value, if readily realizable, of the thing taken in payment is the amount to be included as income. If the services were rendered at a stipulated price, in the absence of evidence to the contrary such price will be presumed to be the fair value of the compensation received. . . . . (Art. 33.)

Rescission of salary contract.—

RULING. A contract was entered into between A and the M Company, whereby the compensation of A for the year 1918, in addition to his salary, was fixed at a certain per cent of the net income from the business. This contract was later modified and a stated amount agreed upon as the maximum liability of the corporation, which sum was paid to A in 1919, in full settlement of the contract for 1918, and was reported by A in his income tax return for 1919. Owing to dissatisfaction on the part of some of the stockholders over the second contract, an agreement was reached whereby the money received by A thereunder in 1919 was returned to the company on March —, 1921, and all rights under the contract waived.

The contracts of employment were fully performed in 1919 when the amount agreed upon was paid by the company to A in full settlement of the contracts. As there can be no rescission of an executed contract there was no obligation upon A to refund any of the money so received. The transfer of the amount to the company on March —, 1921, was purely a voluntary act on his part and for income tax purposes the amount transferred must be considered a gift. (C. B. 5, page 101; O. D. 1073.)

A contract *can* be legally rescinded by mutual consent. It is not necessary to support this statement by legal decisions. It is established business practice. If the foregoing ruling was decided on that point alone, it is not good law.

Premiums paid by employer on group life insurance—not income to employee.—

REGULATION. . . . . Premiums paid by an employer on policies of group life insurance covering the lives of his employees, the beneficiaries of which are designated by the employees, are not income to the employees. . . . . (Art. 33.)

Prior to March 20, 1920, the Treasury held payments of

this character to be additional income of the employee. The employer, however, may deduct such premiums paid as "ordinary and necessary expenses."[17]

Compensation received in property.—

RULING. A taxpayer, an officer of a corporation, voluntarily undertook a difficult mission for the corporation which proved unsuccessful and gratuitously assumed certain responsibilities which facilitated the operations of the company. These acts were never contemplated as a part of his official duties. In recognition of his efforts and these acts of friendship of material value to the company, he received from the corporation certain property, the fair market value of which should be included in his gross income. (C. B. I-1, page 71; Digest I. T. 1262.)

It is doubtful whether the corporation was permitted to deduct the value of the property as an expense. If not so deducted, the value should not be included in the recipient's taxable income.

Compensation received in the form of stock.—

REGULATION. . . . . Compensation paid an employee of a corporation in its stock is to be treated as if the corporation sold the stock for its market value and paid the employee in cash. . . . . (Art. 33.)

The proper valuation of such stock is often a matter of considerable difficulty and its true worth for purposes of taxation in many cases is not the same as the sum shown on the books of the company.[18] When there is an actual market price for the stock such price is the proper one to use. The problem is complicated when there is no market value because the stock is not bought and sold on an exchange, or when the directors have placed an "optimistic" value upon the shares. In case the recipient of the stock is one of the directors and as such has been a party to a formal determination that the services performed were equal in

[17] C. B. 2, page 88; O. 1014.

[18] [Former Procedure] The "actual value" of such stock charged on the books of the corporation as an expense was the basis used previously. (Reg. 33, Art. 139.)

value to the par value of the stock, he would have difficulty in discussing this valuation with a revenue agent. If he was not a party to the valuation placed upon the stock by the corporation, he should return the stock at the value which in his best judgment represents its actual worth, which would also represent the cash value of his services. He would not be bound by a nominal quotation for the stock on an exchange, or by sales prices which might not represent "fair" prices.

The principles followed by the Treasury in fixing the value to be placed on stock received in payment for services, when the value at the date of issuance is unknown, are stated in the following:

Ruling. . . . . It being an entirely new venture, the market price for the stock at the time of the incorporation and the issuance of stock was not known. Shortly thereafter, the taxpayer, as a part of the agreement, proceeded to make a market for the stock. That is to say, he had it listed on the curb and arranged for bringing it to the attention of the public. For his services the taxpayer received in payment shares of the stock of the corporation and voting trust certificates (non-negotiable).

No stipulated cash value appears to have been placed on the taxpayer's services.

Where services are paid for in something other than money, the fair market value of the thing taken in payment is the amount to be included as income. If stock of a corporation is received in payment for services rendered, such stock must be considered as equivalent to cash, providing it has any actual money value. It is to be treated as if the corporation sold the stock for its market value and paid the employee in cash. (See art. 33 of Regulations 45.) To constitute taxable income, however, the value of the stock received must be so fixed as to be capable of measurement at the time of receipt. If its value can not be measured in terms of cash or money's worth, then it can not be considered income for income-tax purposes. (19-19-494.)

The value of stock which has no market price may be estimated by resort to the value of the assets capitalized and attendant circumstances which may affect the value of such assets. (*Goodwin v. Wilbur,* 104 Ill. App., 45; *Collins v. Denny,* 89 N. W., 1012; *Virginia v. West Virginia,* 238 U. S., 202.) In the case of inventions, their value is dependent upon proven utility or the likelihood of practical usefulness and therefore stock issued thereon will have a corresponding value. If an inventor should sell a recently patented invention to a manufacturer before its use has been tested, but simply upon its

apparent usefulness, it may be said that the invention at that time is worth what is paid for it, because a price has been offered and paid. The measure of value is the price paid. (*Burke Hollow Coal Co. v. Lawson*, 151 S. W., 657; *Johnson-Brinkman Commission Co. v. Wabash R. Co.*, 64 Mo. App., 590.) Stock issued upon such invention would be worth the value of the invention, measured by the price which the manufacturer has paid for it.

Where the inventor himself forms a company and issues stock upon his invention and there are dealings in said stock at or within a reasonable time after the issuance thereof, prices then paid may be said to be evidence of the value of the invention capitalized and therefore of the stock at the time of its issuance. This is upon the principle that a subsequently existing fact is evidence of some probative value of the prior existence of the same fact. (See *Humphreys v. Minnesota Clay Co.*, 103 N. W., 338; *Atwood v. Bears*, 8 N. W., 55.)

The taxpayer has received something which he did not have before. If what he has received is of value and that value is capable of measurement, he has received income. (19—19-494, supra.) The fact that the stock received sold in the open market within a very short time after the date of its issue and receipt by the taxpayer is strong evidence that it had value at such date and the prices received in such sales are evidence of the measure of its value within the principles above laid down. However—

In the case of subsequent existence as evidence at the time in issue, there is the disturbing contingency that some circumstance operating in the interval may have been the source of the subsequent existence, and the propriety of the inference will depend on the likelihood of such intervening circumstance having occurred and been the true origin. (Sec. 437, Wigmore on Evidence. See also *Doll v. Hennessy Merc. Co.*, 81 Pac., 625.)

Consequently, even though the inference is strong that the first prices brought in the sale of the stock in question represent its true market value at the date of issue and receipt by the taxpayer, still the activities of the taxpayer in bringing the stock to the attention of the public in a favorable light might have been the cause for a large portion of the prices so received. Such activities can not, however, be said to account for all of such prices. It is therefore fair and reasonable to conclude, in view of the range of prices over a period of two years, that the price received over and above the stated par value was due to the taxpayer's efforts at publicity, and that the value of the stock when received by him was its par value. (See *Moffitt v. Hereford*, 34 S. W. (Mo.) 252.) . . . .

It is therefore held, in the peculiar circumstances of this case, that stock, based upon a new and untried invention, received in payment for services is income to the person receiving the stock to the

extent of its market value. The market value at the time of receipt is to be fixed by taking into consideration the first prices brought for such stock when placed on sale within a reasonable time after such receipt, due allowance being made for intervening circumstances affecting such value. (C. B. 2, page 74; O. 962.)[19]

The foregoing ruling is quoted in full because it describes the Treasury's method of determining gain. When a loss is claimed the Treasury does not use the same formula. When an inventor endeavors to fix the value of his patents at March 1, 1913, he is not given the benefit of such statements in the ruling as this: "In the case of inventions, their value is dependent upon proven utility or the likelihood of practical usefulness." In no part of the ruling is there any mention of the formula of the Supreme Court in defining income. It must be remembered that only income can be taxed, and only income which has been realized to such an extent that it is the equivalent of cash. The Supreme Court has never approved the principle that income can be imputed to a transaction when the stock or other property received has no market value.

Stock purchase schemes for employees.—

Ruling. Where a corporation offers its employees the opportunity to purchase shares of its stock, and the title to the stock remains in the corporation until it is fully paid for, it is held that the so-called dividends credited to the account of the employee purchasing the stock as part payment for the stock are not in fact dividends, as dividends can not legally be declared on unissued or treasury stock. The amounts so credited, which are measured by the dividends declared on the outstanding stock, constitute additional compensation to the employees and taxable as such.

Where other amounts in the nature of special allowances are, upon the fulfillment of certain conditions, credited to the account of such subscriber as part of the payment for his stock, and where provision is made for the payment of certain amounts in the event the subscriber does not default in any payment on the stock being purchased and complies with certain other conditions, it is held that such amounts are in the nature of additional compensation.

It is held, further, however, that as the interest of the subscriber is merely a contingent interest which may be defeated by failure to execute the terms of the agreement upon which the stock is issued,

[19] See Chapters XXI and XXII.

the so-called dividends and special allowances credited to the account of the subscriber do not constitute taxable income to such subscriber until the terms of the agreement have been completed. (C. B. 4, page 76; O. D. 763.)

In the foregoing ruling, what are called dividends are held to be additional compensation to employees, in which case the payments are allowable deductions to the corporation; whereas dividends are not. In order to carry out the purpose of the corporation, stock equal to the aggregate accruing credits should be issued to trustees who can receive and disburse the dividends in behalf of the beneficial owners.

In the following case the corporation issued the stock to trustees, but the result was a contingent rather than a vested beneficial interest in the employees.

Rulings. A corporation issued in the name of its employees shares of its stock as compensation for services rendered. The employees executed the certificate of transfer on each share of stock purporting to transfer the stock to the principal owners of the stock of the corporation, designated trustees. The conditions of the purported issuance and transfer of the stock were that it should be held by the trustees until the dividends thereon, paid regularly to the trustees, should equal the par value of the stock, after which the dividends and stock were to become the property of the employees. In case of resignation or discharge of an employee prior to the time of receiving title to the stock, he was to receive the dividends paid to the trustee on account of the stock issued in his name, and in case of his death they were to be paid to his next of kin.

Held, that title to the stock and to the so-called dividends did not vest in the employees until the conditions imposed by the agreement between the corporation and employees were fulfilled. Consequently the payments made to the principal owners of the stock of the corporation, the amount of which was measured by the dividends paid on the outstanding stock, are not dividends as defined by section 201 (a) of the Revenue Act of 1918, but the amount thereof is additional compensation for services rendered, and constitutes income to the employees in the year in which the title vested in them, subject both to normal tax and surtax.

When title to the stock vests in the employees they should return as taxable income the fair market value of such stock at that time. Any dividends thereafter paid by the corporation would be true dividends as defined by section 201 (a) and subject only to surtax. (C. B. 4, page 76; O. D. 791.)

Where the members of a firm establish an employees' profit-sharing fund by transferring a given sum of money to certain employees in trust, such fund being invested in the business of the firm and the interest paid annually to a certain class of employees, who hold certificates entitling them to participate in the profits of the fund, such certificates being subject to cancellation at the pleasure of the firm, the income from the fund is taxable as a part of the firm's income. . . . . (C. B. 2, page 69; S. 1329.)

There are many forms of profit-sharing funds and plans. The Treasury holds that income from such funds, although paid to the employees, is in the first instance income of the owner of the fund and that such owner is the firm when "such fund is neither a separate business venture nor an irrevocable trust." The ruling is sound. The actual payments to employees are an allowable deduction. The restriction on the deduction applies only when the transfer of funds is in name only.[20]

Ruling. Bonuses paid by a corporation, partly in cash and partly in stock of the corporation, which stock was purchased by the corporation on the open market, in accordance with a plan laid down by its board of directors, to the most deserving of its employees (which must be recognized as meaning most deserving on account of services rendered), represent additional compensation to the employees and as such are deductible by the corporation and taxable to the recipients. The fact that the corporation did not deduct the amount representing these bonuses from gross income in its return would not affect the taxability of the bonuses in the hands of the employees. The amount to be considered as taxable income is the actual amount of cash, plus the market value of the stock, when received by the employees. (C. B. 3, page 144; O. D. 570.)

Compensation received in the form of notes.—

Regulation. Notes or other evidences of indebtedness received in payment for services, and not merely as security for such payment, constitute income to the amount of their fair market value. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, shall treat as income as of the time of receipt the fair discounted value of the note at such time. Thus, if it appears that such a note is or could be discounted on a 6 or 7 per cent basis, the recipient shall include such note in his

[20] See also section 219 (f).

gross income to the amount of its face value less discount computed at the prevailing rate for such transactions. If the payments due on a note so accounted for are met as they become due, there should be included as income in respect of each such payment so much thereof as represents recovery for the discount originally deducted. (Art. 34.)

That is to say, if on October 1, 1922, A received in payment for services rendered a promissory note for $1,000 payable in 6 months, without interest, he would return the discounted value (assuming the current rate to be 6 per cent), approximately $970, as income for 1922. When the note is collected in 1923, he would return $30 as income. The maker of the note, however, is permitted to deduct in 1922 the full $1,000.

If the note bears interest, say at 6 per cent, A would return in 1922 the discounted value, viz., $1,015, and for 1923 he would return $15. The maker of the note would deduct $1,000 in 1922 and $30 in 1923.

If the note could not be discounted no return need be made for 1922. This privilege is extended to instalment houses and it cannot be withheld from others similarly situated.

Ruling. A corporation keeping its accounts on the basis of actual receipts and disbursements loans money, the loans being secured by first mortgages on property of the borrowers. The corporation receives as commission second mortgages on the property payable in 5 or 10 annual installments without interest.

The second mortgage notes received as compensation for services should be reported as income at their fair discounted value as at the date of receipt. If the notes are not marketable at a fair discount value, each installment payment should be included in gross income in its entirety by the corporation in the year in which received. (C. B. 3, page 114; O. D. 728.)

Although notes may be regarded as "good for face value at maturity," as stated in article 34, if not "marketable at a fair discount," the income need not be reported until payment is made.

In the business of architects, contractors and banks, second mortgage bonds are often taken as part payment for

services rendered. These securities usually have no market value. If books are kept on an accrual basis the income to be reported should be on an estimated market or discounted value of the second mortgages. When the books are closed an inventory may be taken since the mortgages are part of the stock-in-trade. If books are kept on a cash basis, the bonds should not be reported as income until realized in cash.

Ruling. A typical transaction of the taxpayer is in outline as follows:

An application is made to the company for a five-year loan of $10,000, to be secured by first-mortgage bonds on certain real estate. A rate of 7 per cent is quoted by the company and accepted by the applicant. The mortgagor executes a first-mortgage bond in the amount of $10,000, bearing interest at the rate of 5 per cent per annum and a note, payable to the company in two years, secured by a second mortgage on the same property, and noninterest bearing until maturity, in the amount of $1,000, which, in this illustration, is 2 per cent on the loan for five years and represents the company's commission for services. The company then offers the bond to a permanent investor, and as an inducement for him to purchase it guarantees by formal contract an interest return of 1 per cent per annum above that provided in the bond.

Held, (1) that only such part of the commission notes received as compensation for services as represents the amount received therefor, or the present worth at the end of the year, be treated as taxable income for each year, and (2) that the company be allowed as a deduction from income only the amount representing the obligations for each on its agreements with investors. (I-30-426; Digest A. R. R. 866.)

Compensation for services received by partnership.—

Ruling. Shares of stock and cash received by a partnership for underwriting the reorganization of an insolvent concern in which a deceased partner owned stock, the transaction being undertaken in order to protect the interests of the decedent's estate and the entire amount received therefrom being turned over to his estate, represent taxable income to the partnership regardless of the fact that no distribution was made to the individual partners and irrespective of the reasons for which the partnership entered into the transaction. (C. B. 2, page 72; O. D. 542.)

The foregoing is apparently based on the assumption that although the partnership was practically engaged in a chari-

table undertaking, it received income for services and made a gift to the deceased partner's estate.

Compensation received in the form of rent and board.—

REGULATION. . . . . When living quarters such as camps are furnished to employees for the convenience of the employer, the ratable value need not be added to the cash compensation of the employees, but where a person receives as compensation for services rendered a salary and in addition thereto living quarters, the value to such person of the quarters furnished constitutes income subject to tax. . . . . (Art. 33.)

Many factory superintendents, as part consideration for their services and not necessarily for the convenience of the employers, are permitted to live, rent free, in houses belonging to their employers. Under this ruling they are required to ascertain the rental value thereof and report it as taxable income. The rental value of a minister's house is exempt from taxation.[21]

While the rules laid down on this point are in themselves equitable, they can scarcely be considered consistent with the rule under which persons owning their own houses are not taxable on the rental value. In other words, there is a discrimination between the man who pays no rent because he lives in the house he owns and the man who pays no rent because he lives in his employer's house, rent free, because of his services. In the latter case income tax is collected on the rental value; in the former case no income tax is assessed on the rental value.

RULINGS. Board and lodging furnished seamen in addition to their cash compensation is held to be supplied for the convenience of the employer and the value thereof is not required to be reported in such employees' income tax returns. (C. B. 1, page 71; O. D. 265.)

Where the employees of a hospital are subject to immediate service on demand at any time during the twenty-four hours of the day and on that account are required to accept quarters and meals at the hospital, the value of such quarters and meals may be considered as being furnished for the convenience of the hospital and does not

[21] Law, section 213 (b-11). See page 381. Prior to 1921, the rental value had to be included in gross income.

represent additional compensation to the employees. On the other hand, where the employees are on duty a certain specified number of hours each day and could, if they so desired, obtain meals and lodging elsewhere than in the hospital and yet perform the duties required of them by such hospital, the ratable value of the board and lodging furnished is considered additional compensation. (C. B. 4, page 85; O. D. 915.)

The following rule differs from the foregoing.

Ruling. The fair rental value of buildings occupied by employees of the Indian service should be included in the compensation of such employees if the rental value has been charged to the appropriation from which the compensation of the employees is paid and the amount covered into the Treasury as miscellaneous receipts. (C. B. 4, page 85; Digest O. D. 914.)

Even though the rental is charged to an appropriation it would seem that the quarters furnished are for the convenience of the employees.

Ruling. The regulations of the Public Health Service provide that officers of such service are entitled to quarters, heat, and light, and that employees, such as attendants, dietitians, internes, nurses, and reconstruction aids, are entitled to quarters, subsistence, and laundry. These items are furnished to such persons in respect of a service which they render and as an inducement to them to enter the Public Health Service.

It is held, therefore, that the value of the quarters, subsistence, laundry, heat, and light furnished the officers and employees referred to constitutes income to such officers and employees and must be returned by them as income for the year in which received. (C. B. 5, page 85; O. D. 1098.)

"Supper money" not taxable.—

Ruling. "Supper money" paid by an employer to an employee, who voluntarily performs extra labor for his employer after regular business hours, such payment not being considered additional compensation and not being charged to the salary account, is considered as being paid for the convenience of the employer and for that reason does not represent taxable income to the employee. (C. B. 2, page 90; O. D. 514.)

Compensation received in the form of heat and light, telephone, automobile and other service.—

Regulation. Amounts received by, or paid for, an officer for heat and light shall be returned as income. (T. D. 2079, November 24, 1914.)

This applies to army officers who receive, in addition to their salaries and allowances for rent, a further allowance for heat and light.[22] Since the amounts paid are readily ascertainable, it may be assumed that all army officers whose aggregate incomes exceed the exemption pay the tax thereon. There are many other individuals who receive allowances of a similar nature and should be taxed thereon. For instance, many corporation officers, particularly those who live near industrial plants, receive or enjoy telephone service, fuel, use of automobiles, and many other perquisites which under the ruling cited are taxable. It is usual for officers of automobile concerns, manufacturers and dealers, to have the full use of motor cars for pleasure and business purposes. Officers of railroad companies receive passes good over their own and other lines. These are used for personal as well as business purposes. An individual, for instance, may use a pass to go to and from his golf club or on pleasure trips.

Should emoluments of this kind be reduced to their equivalent in money and be reported as taxable income? The point is really an important one, for the income tax to be successful must be administered impartially and equitably. If army officers, who are not overpaid, are required to pay the tax on the money equivalent of rent, light and heat, then other individuals, most of whom are better able to pay, ought to pay on similar income. "Compensation for personal service of whatever kind and in whatever form paid" is hardly subject to doubt as to its meaning.

One difficulty which will arise is that of drawing the distinction between compensation which takes the form of reduced living expenses (taxable because not allowable as deductions) and the receipt of similar privileges which do not reduce the living expenses of the recipient. For instance, automobiles are frequently furnished to salesmen exclusively

[22] For details of items to be reported by army officers, see General Staff special income tax memorandum dated March 3, 1919 in *Income Tax Procedure*, 1922, pages 440-441.

for business use. Here, of course, no return would be made. If the salesman is permitted to employ a car for personal or family use, should he ascertain the rental value for the time so used and include such amount as taxable income? The answer is "yes" only in case the salesman would purchase a car himself were this car not furnished free of charge. Only then would the item be the equivalent of a reduction of "personal, living or family expenses." Or, stated another way, return should be made of an amount representing the worth of the automobile service to him personally and individually. If, on the other hand, an officer of an automobile concern has the exclusive use of a car and does use it for other than business purposes, and if it is a fair assumption that he would own and operate a car even if he had to pay for it, then he should ascertain the total cost of operation for a year and prorate such cost equitably, reporting as taxable income the estimated saving of expense arising from the use of the car as additional compensation. Of course, he would report on the basis of what the actual cost to him would be, taking the benefit of manufacturers' or wholesale prices, rather than what he would have had to pay if he had not been in a position to secure such concessions.

There may be in some cases a question as to whether or not some items like the foregoing are compensation or gifts. This probably depends legally upon the contractual relation between the one who pays and the recipient. If the rent, fuel, automobile and similar privileges are part of the employment contracts, express or implied, and thus show on their face that more or less value attaches thereto, the cash equivalent of the items is taxable. If, however, the privileges are not part of a contract and are pure gifts, and if no diminution of cash compensation results therefrom, they do not constitute taxable income.

Compensation received in the form of per diem allowances and mileage.—The 1918 regulations[23] specifically provided that

[23] Regulations 45, Art. 292.

congressmen, army officers and others who received stated allowances per mile or per diem to cover traveling or living expenses, and allowances for stationery, secretarial services, etc. should return as income any excess of such allowances over actual expenses. Article 101 (a) of the present regulations provides, in effect, for the same procedure. In the case of liberal allowances such as congressmen receive, part of the allowance obviously is taxable and the regulation calls attention to this case specifically. In other cases, such as that of army officers, the allowance closely approximates the expenditure and it may not be worth while to attempt an exact accounting. There is, however, a definite obligation imposed upon the recipient to keep such a record as will indicate at the close of taxable periods whether or not return should be made. The record of deposits in one's cheque book usually is sufficient.

The Treasury has held that transportation charges paid by the government on account of the transportation of the families of army officers are in the nature of additional compensation.[24]

Ruling. A person in the service of the American Red Cross receiving maintenance but no pay should return as income any excess of the amount received for maintenance over his actual living expenses. (C. B. 1, page 66; O. D. 11.)

Compensation received in the form of deductions for pension funds, etc.—When deductions are made from the salaries or wages of employees (other than state or municipal employees) to cover compulsory or voluntary contributions to pension, sick or insurance funds, such payments or deductions should be added to the amounts received in reporting income which is subject to tax.

Regulation. . . . . pensions or retiring allowances paid by private persons . . . . are income to the recipients; . . . . (Art. 32.)

[24] C. B. 5, page 174; O. D. 1135.

Tuition fees paid by employer.—

Ruling. Employees of a corporation are required to go to schools not owned by it and maintain a certain average as a condition precedent to continued employment. The amount expended by the company for books, tuition, etc., in connection with the schooling should be included in the gross income of the employees. (C. B. I-1, page 72; Digest I. T. 1304.)

The foregoing is not unreasonable. The amounts expended are properly classed by the employers as compensation paid to or for account of employees.

Unemployment benefits.—

Ruling. Amounts paid by an organized labor union as unemployed benefits to its unemployed members are required to be included in gross income of the recipients. (C. B. I-1, page 63; Digest I. T. 1293.)

Proceeds of accident insurance and damages not taxable.—

Law. Section 213. **That . . . . "gross income"— . . . . (b) Does not include . . . .**

(6) Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness;[25] **. . . .**

See further, Chapter XV.

Insurance proceeds, when taxable and not taxable.—

Regulation. (*a*) Upon the death of an insured the proceeds of his life insurance policies, whether paid to his estate or to any beneficiary (individual, partnership, or corporation), directly or in trust, are excluded from the gross income of the beneficiary. . . . . (*b*) During his life only so much of the amount received by an insured under life, endowment, or annuity contracts as represents a return, without interest, of premiums paid by him therefor is excluded from his gross income. . . . . (*c*) Whether he be alive or dead, the amounts received by an insured or his estate or other beneficiaries through accident or health insurance or under workmen's compensa-

[25] [Former Procedure] Payments made to injured employees by corporations under the accident compensation laws of the several states constitute taxable income of the employees. (T. D. 2570, November 6, 1917.) This was reversed by T. D. 2747 (July 12, 1918), the principles of which are adopted in the present law.

tion acts as compensation for personal injuries or sickness are excluded from the gross income of the insured, his estate and other beneficiaries. Any damages recovered by suit or agreement on account of such injuries or sickness are similarly excluded from the gross income of the individual injured or sick, if living, or of his estate or other beneficiaries entitled to receive such damages, if dead. . . . . Since June 25, 1918, no assessment of any federal tax may be made on any allotments, family allowances, compensation, or death or disability insurance payable under the War Risk Insurance Act of September 2, 1914, as amended, even though the benefit accrued before that date. . . . . (Art. 72.)

Article 72 of Regulations 45 was amended as above to exempt the proceeds of insurance paid to a corporation beneficiary, thus complying with the 1921 law.

The above regulation explains the provisions of the statute, which includes in the exemption amounts paid either to the insured or his estate, together with allotments, allowances, and war risk insurance and compensation.[26]

Ruling. Where an individual takes out a policy of insurance in favor of his estate which is assigned to a corporation as security for money advanced without interest or other charge to pay a premium thereon, and upon the death of the insured the corporation deducts the amount of the indebtedness from the proceeds of the policy paid to it as assignee, and turns the balance over to the executor of the estate, the corporation should not for income tax purposes include the proceeds of the policy in its gross income. The function of the corporation was merely that of an intermediary in the collection of the proceeds of the policy. (C. B. 4, page 72; O. D. 804.)

Premiums paid by corporation—income to officer in certain cases.—

Ruling. If a corporation pays the premiums on an individual life insurance policy carried on the life of one of its officers or employees who is permitted to designate the beneficiary and in which the corporation is not in any way a beneficiary, premiums so paid will, in the absence of satisfactory evidence to the contrary, be presumed to constitute taxable income to such officer or employee. (C. B. 3, page 104; O. D. 627.)

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[26] See page 367 *et seq.*

CHAPTER XVIII

INCOME FROM BUSINESS

The line between the profits resulting from business, dealt with in this chapter, and the profits resulting from appreciation of property, discussed in Chapter XXI, must be somewhat arbitrarily drawn. Most business, of course, consists of dealing in property, while all dealings in property are usually thought of as "business" transactions.

An attempt is made to distinguish between income from the purchase and sale of merchandise, securities and other property by dealers, and income or profits realized by investors and others who are not dealers. General principles regarding the nature and taxation of appreciation of fixed assets and investment securities, real estate, etc., are discussed in Chapter XXII. Sales and exchanges of property (not forming part of a dealer's stock-in-trade) are discussed in Chapter XXI. The discussion of inventories and instalment sales falls within the scope of this chapter but, owing to the special treatment which these subjects require, Chapters XIX and XX, respectively, are devoted to their discussion.

Law. Section 213. . . . . **the term "gross income"—**

(a) Includes gains, profits, and income derived from . . . . trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from . . . . securities, or the transaction of any business carried on for gain or profit, ...

Gross income from business defined.—

Regulation. In the case of a manufacturing, merchandising or mining business "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining the gross income subtractions should not be made for depreciation, depletion, selling

expenses or losses, or for items not ordinarily used in computing the cost of goods sold.[1] (Art. 35.)

Business need not be lawful.—The law of 1913 (section II B) provided that the tax was levied on the gains from "any lawful business carried on for gain or profit." In the law of 1916, the word "lawful" is omitted and it does not reappear in either the 1918 or 1921 law. This would seem to indicate a direct intention on the part of Congress to make "stealings" and "winnings" taxable as well as "earnings." Income from gambling and bootlegging would, of course, come under this head.

In this country there is not a large class of professional gamblers or others transacting an unlawful business, but such as can be reached should be taxed. Occasional betting, however, is frequent, millions of dollars being wagered on the results of political campaigns, athletic contests, etc. The winnings are subject to tax. What they win cannot be termed a gift or any other item specifically exempt from taxation, and "gains derived from any source whatever" are taxable. One should, therefore, include all receipts from bets in his income tax return. This in some cases would be a considerable item in the year of a presidential election. It would seem that net losses are deductible when the transactions were entered into for profit. It would not be wise to claim credit for a net loss arising from betting, but there is a clear obligation to return a net gain.

British practice.—In England it has been held that a professional bookmaker is liable to assessment under the income tax law. The court decided that:

Decision. (Syl.) Persons receiving profits from betting systematically carried on by them throughout the year, are chargeable with income tax on such profits in respect of a "vocation."[2]

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[1] This statement of course does not modify those sections of the law and regulations which permit the use of recognized accounting practices. A taxpayer will not be required to change his method of accounting merely to ascertain items of "gross income."

[2] *Partridge v. Mallandaine,* L. R. 18 Q. B. Div. 276 (1886).

In France, also, the government is taxing income from gambling, as stated in a press dispatch. However, in France, gambling is not "illegal" when conducted under government license.

Those who patronize the lotteries on a large scale and whose quarterly winnings may amount to 1,000,000 francs have learned to their dismay that the new taxes strike a double blow at them.

First they must pay 20 per cent outright to the city of Paris as the tax on unforeseen revenues. Then when they have deposited the balance of their winnings in a bank it becomes a part of their general yearly revenue and is taxable another 15 per cent.[3]

Speculation in "futures," etc.—The purchase and sale of "futures," which chiefly concern those who deal in cotton and other commodities on exchanges, are often called gambling and those who indulge in such transactions do not always consider that their gains are taxable income. It is immaterial whether the transactions are called business dealings, speculation, or gambling. If they result in net gain, the profit must be returned as taxable income.[4]

When does income arise?—The adoption of the accrual method of accounting and the use of inventories do not by any means supply solutions for all the problems bound up in this question. Chapters XXI and XXII are devoted largely to the problem as to when the gains in the value of capital assets and other property are to be accounted for. The following rulings include a miscellaneous set of cases which illustrate the procedure recommended by the Treasury in determining precisely the circumstances under which income can be said to have arisen.

Sales proceeds in escrow.—

Ruling. . . . . Where a sale is made and because of claimants for commissions the seller is required by the purchaser to put a certain part of the purchase price in escrow, and thereafter certain claimants are paid directly out of said funds in escrow, the seller is not liable for

[3] *New York Herald,* November 21, 1920.

[4] For discussion of deductibility of losses, see Chapter XXXIV for inventorying of "futures," see Chapter XIX.

income tax upon any part of the purchase price in escrow until actually received by him. (C. B. 2, page 82; S. 1315.)[5]

A lease of oil lands contained a clause that the lease could not be assigned without the approval of the Secretary of the Interior. The lease was assigned in December, 1916, and the consideration therefor deposited in a bank in escrow pending the approval of the assignment, which was obtained in January, 1917. The Treasury held that title to the money deposited in escrow did not vest in the assignor until the approval of the assignment of the lease by the Secretary of the Interior, and therefore was income to the assignor in 1917. (C. B. I-1, page 80; L. O. 1082.)

Export sales.[6]—Ordinarily there is little difficulty in determining "gross income"; but the question has arisen in the case of exporting firms, as to whether or not they should include in income the profit from sales of goods shipped to customers against open drafts before the collecting banks in the foreign country report payment of the drafts.

Ruling. A corporation ships goods to foreign countries with the understanding that legal title does not vest in the purchaser prior to his acceptance of the draft which accompanies each bill of lading.

Held, that the profits from the sale should not be included in the gross income of the corporation until the draft has actually been accepted and notice of that fact has been received by the corporation. Any goods shipped, the sale of which was not actually consummated as indicated above prior to the close of the corporation's taxable year, should be included in the closing inventory for that year. (C. B. 4, page 94; Digest O. D. 824.)

Railroad adjustment on order of I. C. C.—

Ruling. Adjustments made in accordance with instructions from the Interstate Commerce Commission, increasing the income of a railroad corporation from transactions in prior years and taken up on the books of the corporation during the taxable year because necessary information was not available prior to that time, represent income for the years during which the transactions took place instead

[5] See also C. B. I-1, page 90; I. T. 1212.

[6] Income tax on business from exporting held not to be a tax on articles exported and therefore constitutional. *Peck v. Lowe*, 247 U. S. 165, 38 Sup. Ct. 432, 62 L. Ed. 1049.

of the taxable year. Corrections should be made by means of amended returns. (C. B. 1, page 58; O. D. 9.)

Guaranty under Transportation Act, 1920.—

Ruling. Any amount representing a guaranty deficit received by a railroad company from the United States Government under the provisions of section 204 of the Transportation Act of February 28, 1920, constitutes income to the company for the taxable year in which the deficit was sustained. (C. B. I-1, page 91; I. T. 1326.)

Commissions deposited with court.—

Ruling. A restraining order of a court required that a part of the commissions received by the petitioners should be deposited with the Clerk of the Court, pending a determination of the ownership thereof, upon which determination the amounts deposited were to be refunded to the petitioners or distributed to their patrons from whom they were collected.

Held, that the commissions deposited need not be included in gross income until the taxable year of the judicial determination. (C. B. 5, page 97; Digest O. D. 980.)

Profit on consignment sales.—

Ruling. Profit on goods sold by a consignee is income to the consignor for the year in which the sales are made, even though the consignor received no notification of sale until a subsequent year. If reported otherwise, amended returns should be filed. (C. B. 1, page 66; O. D. 13.)

Computation of business income of contractors.—The business of contracting offers some peculiar difficulties in the calculation of income. The regulations deal with them as follows:

Regulation. Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used herein the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year. Persons[7] whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon the following bases:

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[7] [Former Procedure] Under the old regulations this special provision for contractors applied only to corporations (Reg. 33, 1918, Art. 121). The term "person," as used in the 1918 and 1921 laws, includes individuals and corporations.

(*a*) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection with the work under the contract but not yet so applied. If, upon completion of a contract, it is found that the taxable net income arising thereunder has not been clearly reflected for any year or years, the Commissioner may permit or require an amended return.

(*b*) Gross income may be reported in the taxable year in which the contract is finally completed[8] and accepted if the taxpayer elects as a consistent practice to so treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

Where a taxpayer has filed his return in accordance with the method of accounting regularly employed by him in keeping his books and such method clearly reflects the income, he will not be required to change to either of the methods above set forth. If a taxpayer desires to change his method of accounting in accordance with paragraphs (*a*) and (*b*) above, a statement showing the composition of all items appearing upon his balance sheet and used in connection with the method of accounting formerly employed by him, should accompany his return.[9] (Art. 36.)

This regulation permits a contractor to use his own accounting method, if such method clearly reflects the income, or to change to one of the bases designated by making the necessary adjustments in his accounts.

It has been held that having elected to report on the basis of completed work, amended returns will not be accepted on

[8] A contractor keeps books on an accrual basis. When the contract is completed the final income must be computed and returned in accord with the regulations whether the work is paid for in full or in part. (C. B. 5, page 87; O. D. 1147.)

[9] [Former Procedure] Regulations 33 and T. D. 2161 (February 19, 1915) did not provide for the adjustment of income of any year which had been overstated or understated, by the filing of amended returns for such period, whereas such provision was contained in Reg. 45, Art. 36.

another basis. A change of basis was allowed, however, as to subsequent years. For Treasury ruling, see C. B. 4, page 86; O. D. 933.

A foreign corporation having a long-term contract from which it had no net income from the United States but from which it had received gross income in 1919, was required to file a return showing "its election to report any profit derived from the contract in the year in which it would be completed." (C. B. I-1, page 292; I. T. 1170.)

Contractors should be able to prepare their accounts on the accrual basis. Their difficulties are by no means insurmountable.

Proceeds of Property Requisitioned or Destroyed[10]

Special provision has been made to prevent excessive taxation in cases where compensation is received for property lost or destroyed through fire, storm, shipwreck, or where property is taken under right of eminent domain or requisitioned by the government for war purposes,[11] which is temporarily not replaceable. In such cases "replacement funds" may be established and the tax accounting postponed "for a reasonable period of time."

Law. Section 214. (a) .... (12) If property is compulsorily or involuntarily converted into cash or its equivalent as a result of (A) its destruction in whole or in part, (B) theft or seizure, or (C) an exercise of the power of requisition or condemnation, or the threat or imminence thereof; and if the taxpayer proceeds forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a corporation owning such other property, or in the establishment of a replacement fund,

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[10] [Former Procedure] T. D. 2706 (April 25, 1918) provided relief only in cases of property lost through war hazards. But A. R. M. 101 (C. B. 3, page 110) made the broader provisions of Regulations 45 retroactive to 1917. Section 214 (a-12) is to be applied retroactively as far as may be practicable.

[11] C. B. 4, page 43; O. D. 897.

then there shall be allowed as a deduction such portion of the gain derived as the portion of the proceeds so expended bears to the entire proceeds. The provisions of this paragraph prescribing the conditions under which a deduction may be taken in respect of the proceeds or gains derived from the compulsory or involuntary conversion of property into cash or its equivalent, shall apply so far as may be practicable to the exemption or exclusion of such proceeds or gains from gross income under prior income, war-profits and excess-profits tax acts. . . . .

The most important development in 1922 is the decision of the Treasury to tax proceeds not used in replacements, determined in 1920, at the 1918 rates.[12]

The Treasury has held that the redemption of Victory 3¾ per cent notes is not an "involuntary" conversion because the taxpayer was on notice when purchasing the notes that the government had the right to redeem them on June 15, 1922.[13] The provisions apply also to farm and residential property.[14]

LAW. Section 202. . . . . (d) . . . . (2) Where property is compulsorily or involuntarily converted into cash or its equivalent in the manner described in paragraph (12) of subdivision (a) of section 214 and paragraph (14) of subdivision (a) of section 234, and the taxpayer proceeds in good faith to expend or set aside the proceeds of such conversion in the form and in the manner therein provided, the property acquired shall, for the purpose of this section, be treated as taking the place of a like proportion of the property converted. . . . .

The following features of the 1921 law pertaining to the establishment of a "replacement fund" are important.

1. The acquisition of 80 per cent or more of the stock of a company owning property similar to that lost is deemed a replacement. Under the old regulations it was necessary to "replace the property" lost or destroyed.

2. Under the 1921 law an amount of the gain resulting from recovery may be deducted, based on the proportion of such proceeds expended for replacement to total proceeds.

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[12] See page 453.
[13] C. B. I-1, page 190; I. T. 1354.
[14] C. B. 2, page 78; O. D. 513.

Assume the following:

Cost of asset destroyed		$200,000
Less: Depreciation to date of conversion		50,000
Depreciated cost		$150,000
Amount recovered		250,000
Profit deferred		$100,000
Amount expended in replacing assets substantially in kind	$150,000	
Amount of profit allowed as deduction from income:		
$\frac{150{,}000}{250{,}000}$ of $100,000 =		60,000
Taxable profit		$ 40,000

The old regulation dealing with the profits to be reported reads: "the excess of the amount received over the amount actually and reasonably expended to replace or restore the property.[15]

The foregoing regulation was drafted at a time when replacement costs were greatly in excess of normal, and undoubtedly it was not expected that replacement would be made at an amount less than original cost or March 1, 1913, value. However, if property was replaced in 1920 at less than cost, the gain would be measured by the excess of the amount recovered over cost or March 1, 1913, value. In other words, the higher basis would be used in computing the profit.

3. The property acquired takes the place of a like proportion of the property converted. In the illustration above, the property acquired would be assigned a "cost" of $\frac{150{,}000}{250{,}000} \times \$150{,}000$, or $90,000, for the purpose of computing gain or loss on subsequent sale, and for depreciation.

4. The provisions of the 1921 law are made retroactive to all prior income and profits tax laws as regards exemption from tax.

Regulation. Sections 214 (a) (12) and 234 (a) (14) of the statute deal with cases where property is compulsorily or involuntarily converted into cash or its equivalent as a result of fire, shipwreck, theft,

[15] Reg. 45, Art. 49.

condemnation or similar causes enumerated in the statute. Under regulations prescribed by the Commissioner with the approval of the Secretary, the taxpayer is permitted to deduct gains which may be thus involuntarily realized (through insurance or otherwise) when he proceeds forthwith in good faith to expend the proceeds of such conversion (1) in the acquisition of other property of a character similar or related in service or use to the property so converted, (2) in the acquisition of 80 per cent or more of the stock or shares of a corporation owning such other property, or (3) in the establishment of a replacement fund. When only part of the proceeds of such conversion is thus expended (for example, one-third) a corresponding part of the gain (in the example given, one-third) may be deducted. The statute also provides that for the purpose of determining gain or loss the property acquired takes the place of a like proportion of the property converted (in the example given, one-third). See section 202 (d) (2) and article 1567.[16] The new or restored property, to the extent of the replacement, shall not be valued in the accounts of the taxpayer at an amount in excess of the cost of the old property (or of its value as of March 1, 1913, if acquired before that date and such value is higher than the cost) after making proper provision in either case for depreciation of the original property, plus the cost of any actual additions and betterments. . . . . (Art. 261.)

The law gives the taxpayer his choice of three lines of procedure.

1. To replace the property with property similar in character or related in service.
2. To acquire a minimum interest of 80 per cent in the stock of a corporation owning such property.
3. To establish a replacement fund.

If a shipping company suffers the loss of one of its ships, and to obtain the use of another purchases 80 per cent or more of the stock of another company owning a ship which can be used to replace its loss, such purchase of stock is deemed a replacement.

Should the taxpayer not elect to follow any of the three courses of procedure outlined above, any gain accruing from the transaction is taxable.[17]

As examples of the Treasury's interpretation of what con-

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[16] See Chapter XXII.
[17] Art. 262.

stitutes a replacement, it should be noted that a larger vessel, but one of the same general type as the one lost, was held to be a replacement.[18] However, barges replacing a tug,[19] and a steamship acquired from an affiliated company, were held not to be replacements.[20]

When the proceeds of property taken by a city for public purposes were applied in reduction of an indebtedness incurred in connection with such property, such a conversion does not come within the provisions of section 214 (a-12). (I-27-385; I. T. 1378.)

Replacement funds.—

REGULATION. In any case where the taxpayer elects to replace or restore the converted property, but where it is not practicable to do so immediately, he may obtain permission to establish a replacement fund in his accounts in which part or all of the compensation so received shall be held, without deduction for the payment of any mortgage, and pending the disposition thereof the deduction shall be tentatively allowed. In such a case the taxpayer should make application to the Commissioner on Form 1114 for permission to establish such a replacement fund and in his application should recite all the facts relating to the transaction and undertake that he will proceed as expeditiously as possible to replace or restore such property. The taxpayer will be required to furnish a bond with such surety as the Commissioner may require for an amount not less than the estimated additional income and war-profits and excess-profits taxes assessable by the United States upon the income so carried to the replacement fund. . . . . The estimated additional taxes, for the amount of which the claimant is required to furnish security, should be computed at the rates at which the claimant would have been obliged to pay, taking into consideration the remainder of his net income and resolving against him all matters in dispute affecting the amount of the tax. Only surety companies holding certificates of authority from the Secretary of the Treasury as acceptable sureties on Federal bonds will be approved as sureties. The application should be executed in triplicate, so that the Commissioner, the applicant, and the surety or depositary may each have a copy. (Art. 263.)

Proceeds from sale of vessels returned by the government

[18] C. B. 1, page 76; T. B. M. 61.
[19] C. B. 1, page 77; O. 914.
[20] C. B. 5, page 94; A. R. M. 142.

in an unfit condition were permitted to be held in a replacement fund.[21] The excess of cost of replacement over insurance received was held to be a capital investment.[22] Cash received from the Alien Property Custodian as a return of property seized by him may be placed in a replacement fund.[23]

The computations necessary in connection with the establishment of a replacement fund may be best illustrated by the following examples:

RULING. . . . . 1. When recovery "is less than damage sustained:"

Cost of asset	$5,000.00		
Replacement cost	$5,000.00		
		Recovery	$4,000.00
		Loss	$1,000.00

2. When recovery is "less than an amount necessary to make good the damage:"

Cost of asset	$5,000.00		
Replacement cost	$11,000.00		
		Recovery	$10,000.00
		Loss (?)	$1,000.00

The investment, at cost, as indicated in each of the above illustrations is $5,000. This is the capital sum that may be returnable through depreciation or claimed as a loss if the asset is damaged or destroyed. In the recovery for loss or damage there is necessarily a conversion. In this conversion there would ordinarily be an immediate profit or loss determined by the amount of recovery. But under Treasury Decision 2706 . . . . the determination of the profit or loss is deferred. . . . . The *excess of the amount so recovered* "over the value or cost of the property, *except so far as actually used* for the replacement of the property in kind, is subject to the income, war income, and excess profits taxes." This decision, therefore, provides for the determination of gain by use of the replacement fund. If the entire fund is expended to replace in kind there is no profit or loss because an asset of no greater or lesser value has been acquired. Substantially there is no conversion—merely a substitution. . . . .

The substitution of the asset "in kind" is only one transaction and the profit or loss is measured by the use of all or a part of the replacement fund—not by an amount in excess of the replacement fund. Thus, if the recovery (as in illustration No. 1) was $4,000 on an asset valued at $5,000 and it cost $5,000 to replace the asset, the de-

[21] C. B. 1, page 78; T. B. R. 41.
[22] C. B. 3, page 110; O. D. 697.
[23] Sec. 214 (a-12) reads "as a result of . . . . seizure."

ductible loss is $1,000. But if the recovery (as in illustration No. 2) was $10,000 the immediate profit of $5,000 can not be converted into a loss of $1,000 if it cost $11,000 to replace the asset. Any expenditure in addition to the amount recovered and held in the replacement fund represents the conversion of a current asset (cash) into a fixed asset. . . . .

The Committee accordingly concludes that an amount in excess of recovery for loss expended for replacement of an asset "in kind" is not deductible as a loss when the entire fund so recovered is equal to or greater than the book value of the asset. (C. B. 4, page 92; extract from A. R. M. 122.)

The foregoing ruling would work out as follows: A concern owned a ship which was carried on its books at cost (or value March 1, 1913), less normal depreciation, viz., $100,000. In 1919 it was lost or destroyed. Insurance amounting to $300,000 (its insurable value) was collected. Under the regular practice income and excess profits taxes would be collected on $200,000. On the assumption that it would cost $300,000 to replace the old ship with a new one no better than the old, the 1921 law (retroactive in this respect to taxes under previous income and profits tax laws) permits the taxpayer to credit the entire amount received to a replacement fund, and to withhold the payment of any tax on the excess received, provided[24] bond is filed for the tax which would be due if immediately assessed. If a new ship, which is "substantially" the same as the old, is purchased out of the replacement fund, at a cost of $300,000, no tax will be payable if the new ship is carried in the accounts of the taxpayer at an amount not greater than that at which the old ship was carried.

If the replacement is made at a cost of less than $300,000, say for $150,000, the gain to be reported is that proportion of the proceeds in excess of cost which the amount expended for replacement bears to the amount recovered, viz.,

$$\frac{150{,}000}{300{,}000} \text{ (or } \tfrac{1}{2}\text{) of \$200,000, or \$100,000.}$$

Under the 1921 law [section 202 (d-2)] a new prorated

[24] Art. 263.

"cost" ($50,000) would be assigned to the replaced property, viz., that proportion of the cost of the property converted ($100,000) that the amount expended for replacement ($150,000) bears to the amount recovered ($300,000), that is, one-half. If the replacement cost is $350,000, the excess of cost over compensation received, viz., $50,000, must be added to the book cost, and must not be taken as a loss.

The provision that the new ship must not be valued on the books at more than the book value of the old one is equitable, because if it were valued in excess of the book value of the old ship there would be an amount credited to profit and loss account upon which no tax had been assessed.

One year limitation on fund.—

Ruling. . . . . The period during which the replacement fund may be maintained may properly be limited to one year with the privilege of the taxpayer to apply at the end thereof for a further extension of time. (C. B. 1, page 76; Digest T. B. M. 61.)

When is "gain derived" from conversion and replacement of property.—

Ruling. . . . . "The M Company lost a steamship through war hazard on ...., 1917, and was awarded compensation by the United States Bureau of War Risk Insurance in the amount of 500*x* dollars on ...., 1918, for which a replacement fund was established. The vessel was replaced in the year 1920, and the taxpayer shows a gain of 45*x* dollars through replacement and claims that it is subject to tax in the year 1920."

. . . : the gain is in all cases to be included in gross income for the year in which realized (through receipt of insurance or otherwise), but where the taxpayer places the entire receipts in a replacement fund, he is permitted upon compliance with the regulations "tentatively" to deduct the entire amount of gain, subject to a possible redetermination of the amount of the deduction when he actually effects the replacement. Upon such redetermination, necessitated by nonuse of the entire fund for the purposes specified in the statute, the amount of the gain in the gross income remains unchanged, but the amount of the deduction is diminished. This process, required by reasonable regulations which are expressly authorized by this section of the Act, clearly contemplates taxing the gain in the year in which derived through receipt of insurance or otherwise. There is no injustice in this method, since as a matter of fact the gain is

actually derived in the earlier year, and it is the taxpayer who voluntarily postpones to a later period the final determination of the exact amount thereof. The actual realization of gain or loss depended in the present case upon whether the amount of the insurance was greater or less than the value of the destroyed property and the date of such realization is not affected by the establishment of a replacement fund or by the subsequent replacement. . . . . (C. B. I-1, page 190; Sol. Op. 135.)

It is reasonable to hold in cases of cash realization, where the law permits taxpayers to postpone any accounting for profits, and further permits the gross proceeds to be used in replacements, that if the funds are not used, or if the replacements do not exhaust the proceeds, any realized gain is taxable for the period during which recovery was made. Other taxpayers are so taxed, and the special treatment can no longer be accorded to this class of taxpayers when the special reason for it no longer exists.

Recoveries for Damages, Patent Infringement, Claims, Bad Debts, etc.

Regulation. Gains, profits and income are to be included in the gross income for the taxable year in which they are received[25] by the taxpayer, unless they are included when they accrue to him in accordance with the approved method of accounting followed by him. . . . . A person may sue in one year on a pecuniary claim or for property, but money or property recovered on a judgment therefor rendered in a later year would be income in that year, assuming that it would have been income in the earlier year if then received. This is true of a recovery for patent infringement. Bad debts or accounts charged off subsequent to March 1, 1913, because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. . . . . (Art. 51.)

The foregoing article is a fair interpretation of the legal definition of income even though in many cases it has resulted inequitably. When accounts are kept on an accrual basis and

[25] Postponement of collection by reason of moratorium does not entitle taxpayer to omit income from accounts so affected from return for year in which received. (C. B. 4, page 98; O. D. 869.)

an obvious error has been made, the returns of prior years may be reopened and corrected. When income is not reported for taxation because it is not deemed at the time to be taxable income, no just criticism can be imputed to a regulation which holds that if income was not reported when it appeared to accrue it must be reported when it is realized.

When items which have never been included in gross income or which have been charged off as bad are collected, they are *prima facie* taxable income of the year of realization. The courts carry this theory to an extreme not warranted by business practice. Good accounting practice requires that there be taken up as *accrued* and taxable transactions, those which are the equivalent of cash.[26] Accounts and notes receivable due from and recognized by solvent debtors are deemed to be the equivalent of cash. Only in exceptional cases would accruals of uncertain or indeterminate items be sanctioned by good accounting practice. The definitions of income in the law and regulations are strictly limited by the decisions of the United States Supreme Court. These decisions do not require the payment of tax on transactions which are not the equivalent of cash. Any regulation which attempts to set aside this theory is not sound.

Sale of oil from lands in litigation.—Proceeds of sale of oil retained by receiver pending settlement of litigation, and paid by receiver in 1921, was held to be income of that year.[27]

An award in 1918 in respect of 1917 transactions was held to be income of 1918.[28]

An amount received in 1920 because of condemnation of property by city in 1906 was held to be income of 1920 based on the excess over March 1, 1913 value of the claim.[29]

In computing damages the element of value at March 1, 1913, must not be forgotten. In the case of damages for

[26] See page 400.
[27] C. B. 5, page 97; O. D. 1046.
[28] C. B. 2, page 82; S. 1335.
[29] C. B. 3, page 113; O. D. 591.

infringement of patents, etc., it is quite possible that suits not yet settled, or those which have been settled during recent years, include payments which properly apply to the period prior to March 1, 1913.

A taxpayer sued in 1908 to recover damages for patent infringement and in 1911 a United States circuit court rendered a decision in his favor. The case was referred to a master, who filed a final report with the court early in 1918. In the latter part of 1918, the case was compromised, and an amount agreed upon was paid to the taxpayer. The Treasury held: ". . . . the amount received in 1918 does not constitute taxable income for that year, for the reason that the right to receive this amount existed and was a part of the assets of the X Company on March 1, 1913."

Claims.—The word "claims" indicates that liability is disputed. If claimants do not accrue the claims as income and if those against whom claims are made deny liability, it can hardly be held that taxable income arises unless and until there is realization of the equivalent of cash.

It is now well settled that proceeds from claims, judgments, contracts, etc., definitely ascertained and vested before March 1, 1913, although received during some subsequent year, are not taxable net income.[30]

Bad debts.—When accounts or notes receivable have been charged off because they are deemed to be worthless, it is proper to include any subsequent collections on account thereof as taxable income of the year in which realization occurs. It is not good accounting practice to reopen the accounts of previous years under such circumstances; nor is it proper to reopen tax returns under similar conditions. Even if it develops subsequently that poor judgment is used and some accounts which were charged off should not have been charged off, it would bring about indescribable confusion in accounting and

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[30] See Arts 51 and 151.

tax matters if it were permissible to reopen the accounts except under extraordinary circumstances. Business is conducted under ordinary conditions and superhuman knowledge is not imputed to business men. Under the accrual system books of account must be closed and income statements prepared periodically; when reasonable care is taken in closing books, subsequent adjustments must be made in subsequent accounts.

Types of Business Income Taxable and Non-Taxable

Taxable income can only arise from dealings with the public.—The types of business dealings here considered are with the public generally. For purposes of convenience organizations are sometimes set up which operate as separate entities, but are owned entirely by one interest. Reference is not made to the relationship which exists between parent and subsidiary corporations or between affiliated corporations. Such relationships are discussed elsewhere.[31] But there are other cases in which a firm or an individual establishes branch houses or agencies which keep separate sets of books and prepare independent profit and loss statements. If the separation is in form and not in substance, income tax returns should not be made except by the sole owner.

An English firm had an agency in the United States which purchased cotton in the United States and shipped it to England. The cotton was billed to the head office at market prices on the day of shipment. A book profit of several hundred thousand dollars was shown on the books kept in this country. No cotton was shipped to any one except the actual purchasers. Not a dollar of actual profit was realized in this country. An income tax examiner held that a taxable profit was realized because it was shown on the books. The profit was a book profit only. No net income was realized. Upon appeal the inspector was overruled.

Charging or crediting oneself at high or low prices can-

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[31] See Chapter VI.

not produce a profit or a loss. Dealing with the public is necessary to produce profit or loss.

Income from Government agencies.—Coal shipped for export was diverted by the government. The Treasury held that the amounts should be entered in a "suspense account" and on final settlement amended returns should be filed.[32]

The shippers had accounts receivable at the end of 1919 and 1920. If the accounts were not bad at the end of these years they could not, under the regulations, be charged off. There is no basis in the 1918 regulations for "eliminating" doubtful accounts. A proper interpretation of the laws would have permitted making a reserve for the probable loss on doubtful accounts,[33] but the regulations specifically forbade it. The invoking of article 52[34] is versatile but unsound. If permitted to stand it will bring about a vast number of amended returns and the inclusion in the accounts of subsequent years of the amount, if any, recovered.

Amounts paid by the United States in 1919 and 1920 covering earnings of a business taken over and operated since 1914 by the government, were held to be income of 1919 and 1920 since the books of the business were kept on a cash basis.[35]

Amounts paid to bureau of markets by wool dealers.—

Ruling. Reference is made to your letter of April 20 in reference to the taxability under Revenue Act of 1918 of certain amounts collected by wool dealers under the regulations of the War Industries Board covering the wool clip of 1918.

It is the opinion of this Bureau that any amount found by the Bureau of Markets to be accumulated by any such dealers as so-called "excess profits" under such regulations of the War Industries Board which amount is paid over to the Bureau of Markets and not subsequently refunded to such dealer is not subject to taxation as

[32] C. B. 4, page 93; O. D. 816.
[33] Chapter XXXV.
[34] Art. 52, Reg. 45, holding that amended returns should be filed.
[35] C. B. 4, page 180; O. D. 948.

income to him under the Revenue Act of 1918, and accordingly no such tax thereon will be assessed by this Bureau.

In the event that the dealer pays over to the Bureau of Markets any such amounts as aforesaid which he has returned as income and upon which he has paid taxes under the Revenue Act of 1918, the excess amount so paid as taxes will upon examination of the return be credited against any income, war profits, or excess profits taxes or installments thereof due from the taxpayer under any other return and any balance of such excess tax payment will be refunded to him. Claims for credit or refund in any such case should be filed by the taxpayer as provided in Articles 1034 and 1036 of Regulations 45.

However, if any amounts paid by the wool dealers to the Bureau of Markets as aforesaid are subsequently refunded to them by that Bureau, it will be necessary that they promptly file amended returns so as to include such amounts as income for the taxable year in which they were received by or accrued to the taxpayer and to pay the tax properly due thereon.

The above ruling supersedes that embodied in the letter of the Commissioner of Internal Revenue to the Chief of the Bureau of Markets, dated April 23, 1919, relating to the same subject. (Letter to Sherman L. Whipple, Boston, Mass., signed by Wm. M. Williams, Commissioner, dated May 22, 1920.)

Exchange memberships—proceeds of sale not taxable to exchange.—The Treasury originally[36] held that the proceeds of sale of exchange memberships were taxable income to the exchange, but subsequently reversed that ruling and now holds that such proceeds are not taxable.

RULING. . . . . The amount received as deposit from members appears to be no different than the amount received by a corporation from the sale of its capital stock. The purchaser of stock in a corporation can not demand the return of his money and expect to receive it, and neither can the holder of a membership certificate in the M Exchange. When a corporation liquidates, each stockholder is entitled to receive his proportionate share of capital and surplus, likewise upon dissolution of the exchange each member would be entitled to receive his proportionate share of the deposits and any additional sums that had been permitted to accumulate.

Held, that the amount received by the M Exchange from the sale of membership certificates should be treated as received by it in the form of capital, and the amount thereof should not be included in gross income. (I. T. 1280, I-16-233, page 7, modified.) (I-28-400; I. T. 1387.)

[36] C. B. I-1, page 62: I. T. 1280.

Gifts received by corporations not taxable as income.[37]**—**

LAW. Section 213. [Individuals] . . . . "gross income"— . . . . (b) Does not include . . . . (3) The value of property acquired by gift, bequest, devise, ...

Section 233. [Corporations] . . . . (a) . . . . "gross income" means the gross income as defined in section 213, ...

Section 213 (b-3) of the law applies to corporations as well as to individuals. The interesting question arises: How shall a corporation enter gifts on its books? If the values at date of gift are set up in the books, subsequent gains based on book values may or may not be taxable. It would seem to be necessary in all of such cases to ascertain from the donors the cost to them of the property donated and to note the cost in the ledger account. The maximum tax which can be imposed upon the net income of corporations after January 1, 1922, is 12½ per cent. Individuals who own property for less than two years and who desire to sell it, apparently can organize a corporation and donate the property to it. When the corporation sells it the gain can be taxed only at the 12½ per cent rate.

The Treasury has held that upon the rescission of a contract and repayment to the corporation by an employee of compensation paid under the contract in a prior year, such payment was a gift to the corporation. (See O. D. 1073, quoted on page 424.)[38]

Forgiveness of indebtedness.—

REGULATION. The cancellation and forgiveness of indebtedness is dependent on the circumstances for its effect. It may amount to a payment of income or to a gift or to a capital transaction. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income to that amount is realized by the debtor as compensation for his services. If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is

[37] [Former Procedure] For procedure under 1909 and 1913 laws, see *Income Tax Procedure*, 1920, pages 322-323.

[38] For basis of computing profit on sale of gift, see section 202 (a).

a gift from the creditor to the debtor and need not be included in the latter's gross income. If a stockholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation. . . . (Art. 50.)

One of the United States circuit courts of appeals has decided that a debt forgiven is *not* income to the debtor.[39] The court said: "Now, it seems to us hardly arguable that the cancellation of the debt in question was not in the category of capital . . . . The cancellation of the debt was a means of contribution to its capital account, quite as though the money had been contributed by the stockholder only to enhance the value of his stock."

It is suggested that when stockholders or bondholders contemplate making good a deficit, attention should be given to both sides of the transaction. The creditor may desire to claim credit for the transaction as a bad debt deduction.

Outlawed accounts held to be taxable income.—

Decision. (Syl.) The amount of obligations of a railroad corporation carried on the books as liabilities, which became outlawed and were therefore written off during the taxable years 1910 and 1911, represented profit to the company which was properly included in its net income for the year in which so written off.[40]

Voluntary assessments paid by stockholders not taxable.—

Regulation. Where a corporation requires additional funds for conducting its business and obtains such needed money through voluntary pro rata payments by its stockholders, the amounts so received being credited to its surplus account or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding shares of stock of the corporation. The payments in such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual stockholders, and will be treated as an addition to and as a part of the operating capital of the company. . . . . (Art. 544.)

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[39] *U. S. v. Oregon-Washington R. & Nav. Co.,* 251 Fed. 211 (April 24, 1918).

[40] *Great Northern Ry. Co. v. Lynch,* U. S. Dist. Ct., Dist. of Minnesota, 3rd Div., January 10, 1921, (not reported). See T. D. 3147.

If the payments are made as indicated, the stockholders must consider the payments as capital investments. If the corporation is losing money and the stockholders are merely advancing funds with which to pay its debts or losses it might be better to arrange the payments in the form of advances. Failure of the corporation to repay would entitle the stockholders to charge off the advances as bad debts.

Officers' salaries payable by a corporation but waived by the officers, were held to be an addition to the corporation's capital, not income.[41] So also were contributions by stockholders of 70 per cent of their stock in a settlement with creditors.[42]

Taxes paid by vendee for vendor on profits from sale of property are income to vendor.[43]—

An agreement to pay an additional sum to a vendor equal to the tax payable by him is an enforceable contract, but the calculation is a somewhat involved one. The amount payable must be sufficient to pay the tax on the profit plus such additional sum as will enable the vendor to pay the tax on the amount received in excess of the original sales price.[44] The vendee would properly consider that the tax which is paid for the vendor is a part of the purchase price of the property.

Net proceeds of "business" life insurance are not income.— The proceeds of "business" life insurance are not to be included in gross income.[45]

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[41] C. B. 5, page 277; O. D. 1034.

[42] C. B. I-1, page 195; I. T. 1168.

[43] See Telegram to Corporation Trust Co., signed by Commissioner Roper, dated May 2, 1919, quoted in *Income Tax Procedure,* 1922, page 521. See also C. B. 2, page 62; A. R. M. 16.

[44] For computations, see *Income Tax Procedure,* 1921, pages 382, 383.

[45] [Former Procedure] Under all laws prior to 1921, the proceeds of life insurance collected by corporations were included in gross income. Section 213 (b-1) of the 1918 law contains the limiting clause, "to individual beneficiaries or to the estate of the insured." Under the 1918 law the premiums paid on "business" life insurance were offset against the gross amount received on the policies, and the remainder was required to be reported as taxable income.

Regulation. . . . . Under the revenue act of 1921, the proceeds of life insurance policies paid upon the death of the insured to any beneficiary (corporate or otherwise) are not to be included in the beneficiary's gross income. . . . . (Art. 541.)

Although the premiums paid on "business" life insurance are still not deductible when the taxpayer is a beneficiary,[46] the entire proceeds of such policies may be excluded from gross income.

Reserve fund to carry own insurance.—Premiums collected from customers and placed in a reserve fund by an automobile dealer to provide for losses through confiscation, under the Volstead Act, of automobiles sold by him on term contracts, are income in the taxable year in which they are received or accrued.[47]

Of course payments made or liabilities contracted in respect of such premiums are allowable deductions.

Income from instalment proceeds of "business" life insurance.—

Ruling. The option exercised by a corporation beneficiary in allowing the proceeds of an insurance policy to be paid in installments represents in fact an investment of such proceeds. Any interest or profits received over and above the face value of each installment represents taxable income to the corporation for the year in which received. (C. B. 1, page 211; O. D. 66.)

Bonus received in stock.—

Regulation. . . . . Where common stock is received as a bonus with the purchase of preferred stock or bonds, the total purchase price shall be fairly apportioned between such common stock and the securities purchased for the purpose of determining the portion of the cost attributable to each class of stock or securities, but if that should be impracticable in any case, no profit on any subsequent sale of any part of the stock or securities will be realized until out of the proceeds of sales shall have been recovered the total cost.[48] . . . . (Art. 39.)

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[46] Section 215 (a-4).

[47] C. B. 5, page 83; O. D. 1106.

[48] [Former Procedure] Reg. 33, Art. 44, provided that "the entire proceeds derived from the sale or transfer of such (bonus) stock is income subject to the normal and additional tax."

This article is equitable and accords with good accounting practice.

Purchase by corporation of its own bonds at a discount.—When a corporation purchases its own bonds at a discount it is clear that the retirement of the bonds discharges a liability at less than book value, with a resulting credit to surplus.[49]

The conditions precedent are purchase and retirement. A corporation which buys some of its bonds in the open market at less than par and carries them at cost as marketable investments and has no intention of retiring them cannot be held to have realized a profit. The burden of proof is on the corporation to show that the bonds were not retired. If the bonds were resold at a profit, it would be taxable; if resold at a loss it would be deductible.

It has been held that taxpayers' own obligations in the form of corporate bonds are not susceptible of valuation at March 1, 1913, for the purposes of establishing gain or loss from sale or exchange.[50]

Profit on purchase by corporation of its own stock not taxable.—Corporations sometimes purchase their own stock at a price less than par value. If the stock is retired or if it is carried as an asset on the corporation's books at par, the difference between par value and cost should be credited to surplus account. On this point the regulations provide as follows:

REGULATION. . . . . If, for the purpose of enabling a corporation to secure working capital or for any other purpose, the stockholders donate or return to the corporation to be resold by it certain shares of stock of the company previously issued to them, or if the corporation purchases any of its stock and holds it as treasury stock, the sale of such stock will be considered a capital transaction and the proceeds of such sale will be treated as capital and will not

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[49] See Art. 545.
[50] C. B. 5, page 211; A. R. R. 545.

constitute income of the corporation. A corporation realizes no gain or loss from the purchase of its own stock.[51] . . . . (Art. 543.)

RULING. When a corporation transferred certain assets having a book value in excess of the book value on the same date of its capital stock acquired by such transfer and carried to treasury stock account, there took place a capital transaction and not one in which there resulted a loss from the sale, exchange, or other disposition of property. . . . . (C. B. 5, page 207; Digest A. R. R. 693.)

CRITICISM OF FOREGOING REGULATION.—If a corporation were to resell treasury stock at a profit, as is frequently done, there would be no real difference between this transaction and one involving the purchase and sale of the shares of another corporation. When stock is donated or sold to a corporation at a nominal price to enable the corporation to secure working capital the resale of the treasury stock may in fact represent capital and if so the proceeds of the sale are not properly taxable. But if the stock is purchased as an investment any resale at a profit should be held to be a taxable transaction.

TREASURY STOCK—ACCOUNTING PROCEDURE.—In order that stock may be considered as full-paid and non-assessable, and thus provide a means whereby it may be legally sold by the corporation at less than its par value without liability attaching to the purchaser for the difference between the price paid and par, arrangements are frequently made to issue capital stock for property or services in an amount in excess of the actual cash value of such property or services. A part of such

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[51] [Former Procedure]

REGULATION. Treasury stock, wherever and whenever that term is used in connection with the accounts of the corporation or for income-tax purposes, will be held to mean stock which had been previously issued by the corporation and which had been repossessed by it through purchase or otherwise and then carried on its books as an asset. If such stock is resold at a price in excess of its cost upon repossession, such excess shall be returned as income for the year in which resold. Unissued stock, which had been retained by the corporation for the purpose of future sale, will not, for the purpose of the income tax, be considered "Treasury stock," and when sold no part of the proceeds of such sale will be considered taxable income. Nor will there be any deductible loss if such stock is sold at a price less than par. (Reg. 33, 1918, Art. 98.)

stock is then "donated" to the corporation and is thereafter dealt with as "treasury stock." When sold, the proceeds are sometimes treated as income, but the usual and proper disposition is either to credit an account called "Capital surplus" or "Working capital," or, better still, to credit the proceeds directly to the property or asset account which had previously been charged with the gross amount of capital stock issued.

Of course, the amount realized for the donated stock is capital. By a fiction, induced by improper incorporation laws, it is made to appear that on one side the stock is issued for value received at $100 per share, and that on the other side someone who has paid the alleged full value for it hands it back to the corporation as a gift, pure and simple. The courts are supposed to go to the substance of a matter and to ignore the form; but it is questionable if they should be asked to declare as capital what a corporation itself denominates as income. Therefore, the corporation should be careful, in handling the proceeds of the sale of treasury stock on its books, to indicate clearly the fact that the so-called income is actually capital.

Accounting practice is as follows:

> If purchased by the corporation for resale, cost price is the correct basis of book entry; if purchased without specific intention to resell and more than par is paid, the premium should be charged to surplus. In effect, part of the surplus is paid to the retiring stockholder. The par value of the stock purchased should be deducted on the balance sheet from the total stock issued. When the cost is less than par, the purchase price should be carried in the books and in the balance sheet as an asset, but the item must not be included among any other assets. It is desirable that the number of shares should be stated. It is information which should be revealed. Many published balance sheets do show all details, but the practice is not uniform.
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> If acquired by gift, opinions differ as to the form of entry. Because of the legal formalities required to show that the stock has been issued full-paid, the best authorities sanction the setting up of the stock as an asset at par value, offsetting this entry by the creation of a reserve or surplus account which is designated as a capital item, and which is clearly differentiated from the surplus which arises out of profits or which is available for dividends. It is never proper to include any part of the book value of treasury stock among the current profits or as a part of the surplus available for dividends. This

does not apply, however, if stock had been resold at a profit and the profit is realized in cash. As treasury stock is sold or otherwise disposed of, the asset account is credited and an adjustment is made between this account and the reserve or surplus account for the difference between the book value and the proceeds of the sale.[52]

Cash discount on capital expenditures not taxable.—

RULING. Reference is made to your letter of the 15th instant, in which you state that a corporation has purchased a large quantity of equipment and in consideration of making a prompt payment therefor has been allowed a cash discount. You ask to be advised whether or not this discount should be reported as income.

In reply you are informed that the discount allowed to the corporation purchasing this new equipment need not be reported as income, but the cost of the equipment as charged to capital must represent only the net cost after making allowance for the discount in question. (Letter to E. G. Shorrock & Co., Seattle, Washington, signed by Deputy Commissioner L. F. Speer, and dated November 26, 1918.)

This ruling is in accord with what the author believes to be good accounting practice,[53] but opinion on the point is divided.

Income from Government Contracts

The 1921 law re-enacted the provision of the 1918 law which differentiates in several particulars between net income from business in general and net income derived from government contracts. The latter term is defined thus:

LAW. Section 2. . . . . (11) The term "Government contract" means (a) a contract made with the United States, or with any department, bureau, officer, commission, board, or agency, under the United States and acting in its behalf, or with any agency controlled by any of the above if the contract is for the benefit of the United States, or (b) a subcontract made with a contractor performing such a contract if the products or services to be furnished under the subcontract are for the benefit of the United States. The term "Government contract or contracts made between April 6, 1917, and November 11, 1918, both

[52] *Auditing, Theory and Practice, Vol. I,* (1921 edition), by R. H. Montgomery, pages 206-207.

[53] *Auditing, Theory and Practice, Vol. I* (1921 edition), by R. H. Montgomery, page 587.

dates inclusive" when applied to a contract of the kind referred to in clause (a) of this subdivision, includes all such contracts which, although entered into during such period, were originally not enforceable, but which have been or may become enforceable by reason of subsequent validation in pursuance of law.[54]

The purpose in earmarking income from government contracts was to place upon it in years after 1918 a heavier burden of tax than that imposed upon income not derived from war activity. The 1918 profits tax rates apply to such income if received prior to 1922.

Most of the rulings issued by the Treasury on specific cases have involved the question of time, *i. e.*, was there a contract in force between the dates specified in the law, viz., April 6, 1917, and November 11, 1918? This is a legal question, and the Treasury's conclusions in each case are susceptible to revision by the courts.

The Treasury has also ruled[55] that so-called "order contracts" on which the work was done by order of the President under the Naval Appropriation Acts of March 4, 1917, and July 1, 1918, are "government contracts." This ruling, however, is open to serious question,[56] and will no doubt be contested in the courts.

Ruling. A corporation which contracted with another corporation to manufacture and deliver machinery to be used in manufacturing ammunition, but did not produce or furnish ammunition or any component part thereof, nor perform any direct service in connection with the production of ammunition manufactured by another corporation under contract for the United States Government, is not a subcontractor within the meaning of Section 1, Revenue Act of 1918. (C. B. 2, page 12; O. D. 359.)

Supplemental contracts held to be government contracts.—

Ruling. Supplemental contracts made with a department of the United States Government after November 11, 1918, modifying orig-

[54] For method of allocating income from government contracts, and computation of tax thereon, see *Excess Profits Tax Procedure*, 1921, Chapter XVIII.

[55] C. B. 2, page 13; O. D. 477.

[56] See *Excess Profits Tax Procedure*, 1921, Chapter XVIII.

inal contracts entered into between April 6, 1917, and November 11, 1918, between the same parties, are "Government contracts" entered into between April 6, 1917, and November 11, 1918, within the meaning of the Revenue Act of 1918 and the income therefrom is taxable under section 301 (c) of the above Act. . . . . (C. B. I-1, page 5; Sol. Op. 128.)

Form of contract not enforcible.—

RULING. A contract between the Government and a corporation which was entered into and enforceable against the corporation prior to April 6, 1917, but which was not executed in the form prescribed by section 3744, Revised Statutes, so as to become enforceable against the Government until after that date, is not a "Government contract" within the meaning of that term as defined in the Revenue Act of 1918, and the corporation will not be required to compute its tax upon the profits arising therefrom in accordance with section 301 (c) of that act. (C. B. 2, page 13; O. D. 412.)

Allowances for canceled government contracts are income of year in which allowed.—Former procedure has been materially modified by the regulations now in effect. Such items as claims for compensation under canceled government contracts constitute income for the year in which they are allowed or their value is otherwise definitely determined.[57]

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[57] Art. 51. The last sentence of this article applies also to the 1918 law. (I-45-579; I. T. 1489.)

[Former Procedure]

Government contract adjustments.—

REGULATION. . . . . In view of the unusual conditions prevailing at the close of the year 1918 it is recognized that many items of gross income, such as claims for compensation under cancelled contracts, together with claims against contracting departments of the Government for amortization and other matters, while properly constituting gross income for the taxable year 1918 were undecided and not sufficiently definite in amount to be reported in the original return for that year. In every such case the taxpayer should attach to his return a full statement of such pending claims and other matters, and when the correct amount of such items is ascertained an amended return for the taxable year 1918 should be filed. (Reg. 45, Art. 52.)

At the end of 1918, many taxpayers having claims against the government were unable to evaluate such claims because of the inability of government representatives to state the basis of settlement. This does not refer to claims which were disputed by the government, but to claims which were admitted to be due.

If a contractor included in gross income for 1918 a larger or smaller

Foreign exchange.—

RATE OF EXCHANGE ON INCOME ACCRUING ABROAD.—

RULINGS. Income returnable for the purpose of Federal taxes should be expressed in terms of United States money. The rate of exchange at the time of receipt governs in making the computation. (C. B. 2, page 60; O. D. 419.)[58]

The Committee has reached the conclusion that under the abnormal conditions characterizing foreign exchange during the European war, the taxpayer may convert current assets less current liabilities payable in the foreign currency at the current rate of exchange or at any rate less favorable to him. The Commissioner should consider in any case applications to adopt a rate more favorable to the taxpayer or may on his own motion apply such a rate where the facts in the particular case warrant such departure.

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amount as due from the government than has been actually collected, the book profit or loss shown in 1919 is in some cases not an actual profit or loss, but represents a mere adjustment of an estimate as of December 31, 1918. In such cases the proper procedure is to file an amended return for 1918.

The Treasury, however, must be consistent. If it insists on reopening returns for 1918 in order to write back additional profits, when such profits have been determined in subsequent years, it must also allow the reopening of 1917, 1918 or 1919 returns when subsequent determination proves that excessive profits were returned in one or more of those years. It is of course obvious that there is a limit to the reopening of old returns, otherwise taxpayers and the government would indulge in a never-ending competition. Books of account are closed, and always have been closed, on estimates which are more or less inaccurate. A reopening is justified only when a mistake has been made, and the obligation upon a taxpayer to reopen when a mistake is discovered is the same whether it means additional tax or less tax. The reopening of accounts for the purpose of recomputing inventories is much more reasonable than a requirement that accounts for 1918 be reopened in order to include as income disputed claims against the government.

It may be expected that the foregoing procedure will be modified in the light of article 51, Regulations 62, although many additional assessments have been made on the basis of the old regulations. Taxpayers should ask for reconsideration when excessive assessments have been made.

In a recent case, the Treasury at first denied a loss in 1919 because of a government contract adjustment made in 1920, but subsequently permitted the reopening of the 1919 return and the reduction of the 1919 income from Government contract because of its "tentative" character. (C. B. 5, page 131; A. R. R. 685.)

[58] See also C. B. 5, page 66; O. D. 1066.

This ruling should apply primarily to taxpayers trading or manufacturing in foreign countries and should not be held to apply to isolated or collateral investments in foreign credits or securities. (C. B. 2, page 60; A. R. R. 15.)

. . . . In the case of a domestic corporation engaged in business in a foreign country, its assets and liabilities (other than capital assets) recorded on its books in terms of the foreign currency, should be appraised in dollars (whether actually converted or not) at the close of each taxable year in which it is engaged in active business at the current or market rate of exchange, if any, then prevailing. (C. B. 2, pages 60-61; O. D. 489.)

A domestic corporation has a branch office in London which keeps a separate set of books in English currency and renders a report at the end of the year as to the profits. During the year, whenever the branch office has on hand more money than is needed for regular expenses, a remittance is made to the home office.

Held, that the net profits of the London branch for the year should be computed in English currency. From the total profits for the year should be subtracted the total amount remitted to the home office during the year, all expressed in English currency. To determine the equivalent of the profits in terms of United States money, the amounts remitted should be converted into United States money at the rate of exchange in effect at the date such remittances were made. The balance of the net profits, expressed in English currency, should be converted into United States money at the rate of exchange as of the end of the taxable year, regardless of the fact that the profits may not have been remitted to the home office. (C. B. 2, page 61; O. D. 550.)

Liquidation of indebtedness.—The Treasury has evolved a different procedure in cases in which liquidating liabilities to foreign creditors appear on the books in the United States, where remittances are made, not to cover specific invoices, but in a running account which remains open at the end of the year.

The rule laid down requires the averaging of the rate of exchange over the period, instead of applying specific rates to specific transactions or inventorying at the close of the period.[59]

The Treasury's position in regard to foreign items is not

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[59] C. B. 3, page 75; O. D. 590.

entirely clear but the rulings indicate that no attempt will be made to enforce arbitrary or unfair rules.

Ruling. A bank in Germany sent to its agent in the United States a credit in marks equivalent to the amount of dollars desired by its client, a corporation. The corporation thereupon executed its note payable to the German bank in marks and the bank's agent drew his check in the equivalent amount of dollars payable to the corporation. The corporation's liability on the note was settled with the Alien Property Custodian in dollars equivalent to the value of marks borrowed, the mark at the time having a value in dollars about one-twelfth of what it had when the loan was made.

The difference between the amount received in dollars by the corporation in its sale for dollars of the marks it borrowed and the amount paid by the corporation to the Alien Property Custodian is taxable income to the corporation. (I-32-447; Digest I. T. 1411.)

Capital items.—Fluctuations in exchange do not justify corresponding changes in the book values of capital assets or liabilities. The expenditure by a corporation of a million dollars for a building in New York is unchanged on the books, except for depreciation or obsolescence, even though the apparent market value declines one-half. If one million dollars is expended for a building in Paris when francs cost 8 cents and francs happen to be 6 cents at the end of the year, the apparent decline of $250,000 is not an allowable deduction. Capital profits and losses must be realized before they affect income tax computations.

Current items.—The author is of the opinion that current items abroad, such as accounts receivable and accounts payable, bank balances, etc., should be inventoried when the books are closed, as nearly as possible on the basis of cost or market, whichever is lower.

Ruling. A corporation at the time of closing its books for the taxable year had an asset of x pounds sterling represented by advances made in cash to its London representative for the purchase of raw material in the London market. The purchases had not been made at the time of the closing of the books.

The rate of exchange at the time of closing the books was lower than at the date the exchange was purchased.

Held, that the taxpayer did not sustain a loss as contemplated by the statute. . . . . (C. B. 4, page 64; Digest O. D. 940.)

The item of "sterling owned" is a current asset. Under the ruling in C. B. 2, page 61; O. D. 550 (see page 471), it should be inventoried at the rate of exchange in force at the end of the year. It may not be a technical loss, but if allowed as an inventory loss the net result is the same.

When current assets abroad exceed current liabilities and exchange is lower at the end of the year than during the year, a loss will be shown. When exchange is higher, no profit or loss will be shown.

When current liabilities exceed current assets and exchange is lower, no profit or loss will be shown. When exchange is higher a loss will be shown.

The rule is the same in case of one item of current asset or liability as it is in the case of branch houses.

The foregoing is merely conservative business practice and may or may not result in a saving of taxes. Based on market values, losses are taken, but profits are not anticipated.

The Treasury has issued several rulings summarizing the rates of exchange as of December 31, 1916, 1917, 1918, 1919, 1920, and 1921. These rulings will be found in the bulletins as follows:

C. B. 4, page 60; O. D. 772	C. B. 5, page 66; O. D. 1137
C. B. 4, page 60; O. D. 803	C. B. 5, page 66; O. D. 1138
C. B. 4, page 63; O. D. 876	C. B. I-1, page 50; I. T. 1202
C. B. 4, page 63; O. D. 898	C. B. I-1, page 50; I. T. 1315
C. B. 4, page 63; O. D. 913	C. B. I-1, page 51; I. T. 1324
C. B. 5, page 64; O. D. 996	C. B. I-1, page 51; I. T. 1325
C. B. 5, page 65; O. D. 1036	I-44-566; I. T. 1482
C. B. 5, page 65; O. D. 1052	I-44-567; I. T. 1483
C. B. 5, page 65; O. D. 1065	I-46-588; I. T. 1495

CHAPTER XIX

INVENTORIES

The subject of inventories has assumed great importance in income tax matters. It is believed that a proper discussion of the subject justifies a special chapter.

When a concern maintains a stock of any kind of property which is periodically renewed as it becomes exhausted, the proper procedure in determining profit or loss is to inventory the stock. Regarding inventories the law provides:

LAW. Section 203. **That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.**

The 1918 law for the first time gave the Commissioner specific authority to *require* inventories, although they have as a matter of fact been used under regulations of the Treasury ever since the passage of the 1909 law.[1]

REGULATION. In order to reflect the net income correctly, inventories at the beginning and end of each year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. . . . . (Art. 1581.)

Inventory must be taken as of one fixed date for entire business.—

RULING. Taxpayers will not be permitted to adopt one period for inventorying and closing their books applicable to one part of their

[1] **[Former Procedure]** Even under the regulations issued to control the procedure under the 1913 law and in spite of the doubtful authority in the law for the use of the accrual method, the Treasury specified that inventories should be used in certain cases. Art. 161, Reg. 33, January 5, 1914. For 1917, see Reg. 33, 1918, Art. 120.

business and a different period applicable to another part thereof. (C. B. 1, page 62; O. D. 289.)

Inventories in the case of amended returns.—

Ruling. Where amended returns are filed it is not permissible to value the inventories in the amended returns on a basis different from that employed in the original returns, unless the audit of the returns in this office reveals the necessity for employing a different basis. (C. B. 5, page 63; O. D. 1132.)

If inventories have been taken on any basis other than that of "cost" or "cost or market, whichever is lower," amended returns may be filed and either one of the two bases mentioned above may be used.[2] In a specific case in which revenue agents at first refused to recognize a change from "cost" basis to "cost or market, whichever is lower," they assented when an analysis of the method originally used by the taxpayer showed that the basis was not strictly one of "cost."

Who may use inventories.—Specific permission to use inventories has been given in the following:

Dealers in foreign exchange.—

Ruling. A dealer in foreign exchange—that is, one who regularly engages in the purchase and resale to customers of foreign money with a view to the gains and profits that may be derived therefrom—who, in his books of account regularly inventories unconverted foreign money on hand either (a) at cost or (b) at cost or market value whichever is lower, may make his return upon the basis upon which his accounts are kept.

A taxpayer who is not a dealer in foreign exchange but merely purchases foreign money on his own account or as an incident of his principal business may not inventory such unconverted foreign money at the close of his taxable year. The realization of the gain or loss is postponed until the foreign money is disposed of or converted. (C. B. 4, page 61; O. D. 834.)

When foreign exchange is purchased incident to a business such as that of an importer, there would seem to be no good reason why the amount held at the end of the year should

[2] "Market" may be used by dealers in securities (Art. 1585).

not be inventoried. It is to such importer an asset used in trade, and should therefore be subject to the usual rules for valuing trade assets.

Dealers in second-hand automobiles.—

Ruling. A dealer may value used or second-hand automobiles included in a closing inventory on the basis of cost or market, whichever is lower, in accordance with article 1582 of Regulations 45, if he can furnish satisfactory evidence of the market value of such second-hand automobiles at the date of the inventory. . . . . (C. B. 4, page 49; O. D. 888.)

Real estate dealers not permitted to use inventories.—

Ruling. A taxpayer, engaged in the real estate business, is not permitted to inventory real estate which is held for sale for the purpose of calculating net income subject to Federal income tax. (C. B. 4, page 47; O. D. 848.)[3]

Oyster culture—inventories not permitted.—There are some businesses, it seems, in which the use of inventories does not reflect true net income.

Ruling. The net income of a person engaged in the business of propagation and culture of oysters can not be properly computed upon the basis of inventories. Amended returns will be required for those years for which returns have been based upon inventories. The net income is the gross receipts for the year less the necessary business expense and other allowable deductions. (C. B. 3, page 80; O. D. 684.)

Estimated inventories are not permitted.—

Ruling. A taxpayer who for many years has elected to take inventory only every two years, and used an estimated inventory in the return for the intermediate year, making any necessary adjustments in the return for the following year when an actual inventory was taken, may not apportion his total earnings for the two years 1917 and 1918 equally between such years for income tax purposes. (C. B. 1, page 62; O. D. 133.)

It would seem, however, that if an estimated inventory which can be verified by the "gross profit" test has been used

[3] See Chapter XXII with reference to the effect of capital gains provisions arising from denial of inventory privilege.

in former years, and that there is no material fluctuation in the rate of gross profit to the date when an actual physical inventory is taken, such estimate must be acceptable.

What Inventory Includes

REGULATION. . . . . The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption, or use in productive processes, together with all finished or partly finished goods. . . . . (Art. 1581.)

The regulation refers to goods "on hand" which is synonymous with a physical inventory. Physical inventories or their equivalent are absolutely necessary in every concern handling materials or goods; but recognized accounting principles do not require that a physical inventory be taken of everything on hand on a specific date. If a book inventory is trustworthy and the entire stock is actually verified in whole or in part at various times during the year, taxpayers need have no hesitancy in stating that article 1581 has been complied with.

The Treasury has ruled that advances to a foreign corporation by an American firm may not be inventoried, even though a considerable decline in the exchange rate has occurred.

RULING. In taking inventory for the purpose of determining taxable net income in accordance with article 1581 of Regulations 45, it is not permissible to include claims which the taxpayer may have against other persons and which have depreciated in value on account of a decline in exchange rates or for any other reason. (C. B. 2, page 50; Digest O. D. 541.)

In view of the tremendous decline in the principal foreign exchanges, any conservative balance sheet would show such assets "inventoried" at the current rate of exchange.[4] Strictly speaking, the word "inventory" does not include accounts receivable, but a fall in exchange rates is equivalent to a fall in the market value of goods. The accrued loss should be

[4] See page 470 *et seq.*

claimed. Under the 1921 law it can be included in the reserve for bad debts. Goods of a certain value have been exchanged for other property, viz., a chose in action. When valued at the equivalent of cash the chose in action is worth less than the sales value of the goods. True net income cannot be determined unless the resulting loss is taken into account.

Bailments—when included in inventory.—In some branches of business it is customary to send material to other concerns for some form of processing, for instance, bleaching or dyeing. At the date of the inventory such items are included in the inventory if they are to be returned in kind; but some firms have varying arrangements for the return of the "products of the property," such as flour for wheat. In such cases the Treasury holds that this exchange amounts to a sale, and the goods returnable under such arrangements cannot be included in the inventory.

Ruling. The delivery of copper bullion to a smelting and refining company where it is mixed with other bullion and concentrates of different metallic contents under a contract by which the smelting and refining company is to return the equivalent of the metallic contents of such ore previously determined by assay, less commissions and other allowable charges, constitutes a sale and not a bailment. Only so much of the metals as had been redelivered by the refining company at the close of the taxable year belonged to and should have been included in the inventory of the taxpayer as of that date. . . . . (C. B. 2, page 45; S. 1373.)

In the detailed opinion of the Solicitor the general rule is stated.

But the rule is well settled that when, by the terms of the contract under which property is delivered by an owner to another, the latter is under no obligation *to return the specific property either in its identical form or in some other form in which its identity may be traced,* but is authorized to substitute something else in its place, either money or some other equivalent, the transaction is not a bailment, but is a sale or exchange. (*Austin v. Seligman,* 18 Fed. 519, 520.)

The effect of this ruling is to permit concerns to anticipate the profit or loss upon products which have been converted but

not delivered to actual customers. It would apply only to concerns which adopt such practice as a settled policy.

. . . . the refined copper returnable to the M Company on December 31, 1917, and December 31, 1918, should, in each instance, have been set up in an account receivable, and if returns were made on an accrual basis, should have been so returned. There is this difference, however, between such an account and an ordinary account receivable, namely, that it is an account receivable in metal and not in money. Under Treasury Decision 2609 and article 1582 of Regulation 45 the copper actually returned to the corporation prior to the dates stated should have been included in the respective inventories as of those dates at cost, or cost or market, whichever was lower, and it would seem clear that the copper receivable could not have had a different value for the purpose of inventory than that which the copper, if actually received, would have had. For the purpose of determining the value of such account, therefore, the copper receivable should be priced a tcost, or cost or market, whichever was lower.[5] . . . . (C. B. 2, page 45; S. 1373.)

The Treasury in the foregoing case has departed from its usual position and has required receivables to be inventoried as if no sale had been made.

In a later decision the Treasury held similarly.[6] In that case a further question was raised as to whether the so-called "receivables in metal" due from the smelter, which were subsequently sold for future delivery by a selling agency of the mining company, could be considered a sale or an inventory item.

Ruling. . . . . It appears from the facts in this case that at the close of the years 1916 and 1917 the R Company [the selling agency] was oversold. At those times, therefore, there could have been no amount of copper, or, at least, no adequate amount of copper belonging to the M Company [the mining company] upon the stock pile of the Q Company [the refinery] out of which shipments or deliveries on the various dates shown for the following years could have been made. The advice to the M Company, therefore, during the closing months of 1916 and 1917 of sales of copper for shipment or delivery in the following years could not have constituted sales of copper, since the copper was not in existence. The cases of *Field v. The Mayor,*

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[5] Art. 1582 permits the inventory, under certain conditions, to be taken at less than cost or market. See page 487.

[6] C. B. I-1, page 32; L. O. 1087.

etc., of New York (6 N. Y., 179) and *Williams et al. v. Ingersoll et al.* (89 N. Y., 508), cited by counsel for the M Company, support this position. . . . .[7]

The two cases cited by the Solicitor, as given above, cannot be taken as controlling. The first was an assignment of a right to the payment of bills by a city for job printing "when the same should become due," although at the time there was no contract with the city for the work. This is a far cry from the millions of dollars of copper which in 1916 and other years were sold for future delivery. The Solicitor concludes:

. . . . If, then, we were to regard the contract between the M Company and the R Company as a general assignment of the copper contents of its ore by the M Company to the R Company, such assignment could not take effect until the copper was placed by the Q Company upon its stock pile at the end of a period of —— days when it became deliverable to the M Company. Prior to that time the M Company had no copper to assign, and the assignment could not take effect until the M Company became entitled to the copper. . . . .

The foregoing is a highly technical interpretation which may not be sustained by the courts.

A stronger case is that of a mining company which receives from the smelting company negotiable copper warrants evidencing its right to receive a definite number of pounds of copper. Such a warrant is negotiable. The mining company is notified that the copper has been sold and the company has therefore concluded a sale of copper for future delivery. The selling agents have exercised their legal right to put the copper itself beyond the reach of the mining company. Thereafter the mining company has an account receivable collectible only in money. Even before the sale, the mining company receives a negotiable warrant which is superior in security to an ordinary account receivable, because such warrants are customarily sold or pledged as security on the basis of the market price of copper which includes the mining company's profits. The company has realized its profits. It has cash,

[7] *Ibid.*

or negotiable warrants, to inventory—not copper. To call such an item at the close of the year, "inventory of copper on hand" requires strained reasoning. The mining company is no longer interested in the copper, never sees it, and does not even know the purchaser of the metal. Even though legal title has not passed, the net income may be said to have been realized. (See page 484. Also C. B. 2, page 84; L. O. 988; and I-47-600; A. R. M. 189.)

Goods purchased but not delivered.—In all cases when goods have been shipped the consignee should consider the goods as part of his inventory and include the full purchase price among his liabilities. If the market price of the goods at closing time is less than cost the inventory should be reduced.

REGULATION. . . . . Only merchandise title to which is vested in the taxpayer should be included in the inventory. Accordingly the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold, title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased, title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery transfer of title to which has not yet been effected. (Art. 1581.)

The proper taking of "in transit" and other parts of the inventory is facilitated by planning ahead of the inventory date. Careful segregation and compilation of information on the following points will avoid neglect of matters which are often overlooked:

1. Invoices received for goods not yet received.
2. Goods received but no invoices.
3. Goods returned by customers but credit not yet passed.
4. Goods returned and billed back by customers but not yet received.
5. Goods on consignment.

6. Goods at other plants for processing or which are held on order.
7. Goods sold awaiting shipment but not yet billed.

When contracts have been entered into for future delivery, and such contracts are not subject to cancellation, it may be important to consider whether or not any loss has arisen in respect thereof. If the goods were set aside by the seller and charged on the seller's books to the purchaser, the latter should also reflect the transaction in his books. Otherwise the profit to the seller would have appeared in his tax returns for 1922, but the shrinkage in value, if any, to the purchaser would not have appeared in the latter's returns until after 1922.

If the goods are not dealt with as sales by the seller, the purchaser can hardly expect to take up any loss on his books.

It may be urged that if a purchaser contracts in November, 1922, for cotton goods to be delivered in January, 1923, and at December 31, 1922, the market price is 10 cents a yard less than the purchase price, he should be able to deduct the 10 cents a yard loss in his 1922 returns as reflecting the market price on December 31, 1922. The answer is that goods not received may never be received; that before the goods are received the market may again advance, and that no loss has been realized.

On the other hand, a true balance sheet of the purchaser would show a reserve for the loss accrued to December 31.[8]

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[8] "The balance sheet, for instance, might show stock on hand large enough or too large for the normal requirements of the business. Unfulfilled contracts outstanding at the date of the balance sheet which call for the receipt of additional stock, which may not be readily salable, will result in an actual liability, whereas the offset, the stock to arrive, will be an asset of doubtful value.

"In every audit, therefore, the auditor should call for copies of all orders for future delivery. If such orders call for stock in excess of the current and reasonable prospective demand, mention thereof should be made in the balance sheet. The details reported should depend on the circumstances of each particular case." [*Auditing, Theory and Practice*, Vol. I (3rd edition), by R. H. Montgomery, page 260.]

If the loss must be set up to reflect actual conditions, there must be some merit in the contention that true net income for the year 1922 cannot be determined unless and until what has taken place in 1922 is reflected in the tax returns.

When there is a considerable shrinkage in prices and it is desired to reflect in the current year the accrued losses on forward orders, it is legal and proper, prior to the closing date, to cancel orders, pay the loss due to cancellation, and reinstate the orders at the current market prices.

In some trades it is customary to place orders for future delivery on the books. In such cases the inventory-at-market basis would enable credit to be taken for the loss in 1922. If such a custom has been followed for a period of years or is general in a trade, it may be continued. Otherwise the practice should not be initiated as at December 31, 1922. Taxpayers are on notice, however, that the Treasury has ruled that goods to which title has not passed to the purchaser cannot be inventoried by him.

A question arose from a claim for loss under section 204,[9] due to decline in value of the inventory, as to whether or not the material covered by contracts for future delivery could properly be included in the inventory.[10]

> RULING. . . . . On September 30, 1918, none of the X material on account of which losses were subsequently sustained had been delivered to the company, and hence none was included in the inventory on which the assessment for 1918 was made. The company did not at that time own this X material, and presumably much of it had not even been produced. The company did not own it but only had a contract for its purchase. It could not, therefore, have properly been included in an inventory of the company's property as of that date. . . . . (C. B. 3, page 88; T. D. 3044.)

Whether or not goods may be included in the inventory depends in some cases on whether title has passed. The answer to the latter question is a legal proposition. The points to be observed are:

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[9] 1918 law.
[10] See Chapter XXXIV.

1. Were the purchase contracts executed prior to the close of the fiscal period?
2. Were the goods covered by the contracts in existence and in a deliverable state at the close of the year?
3. Were the goods segregated and appropriated to the contracts? If the goods were in transit they constituted specific property requiring no segregation.
4. Were the goods, when subsequently delivered, handled as sales on credit, i. e., were they delivered without payment being demanded?

   Even though terms of payment were sight draft against bill of lading, the intention of the parties would govern, as where the purchaser (with the seller's consent) covered such merchandise with insurance.

If most of the foregoing questions can be answered in the affirmative, a strong case can be made out that title has passed and the goods should be inventoried by the purchaser.[11]

In cases where the Treasury has held that a transaction was a closed one in a high tax year, the Solicitor has not hesitated to rule that "the postponement of transfer of a legal title is not decisive" (C. B. 2, page 84; L. O. 988), and "in deciding whether the transaction was a sale it is immaterial that the legal title did not presently pass" (I-47-600; A. R. M. 189).

Futures.[12]—During the year 1921, the Treasury removed its inhibition against the inclusion in the inventory of such futures as constitute "hedges" against actual spot or cash transactions. Prior to the issue of A. R. M. 135, the Treasury had consistently refused to permit the inclusion of

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[11] See *Williston on Sales*, 1919 Edition, page 350, 363, 407; also *Benjamin on Sales*, Seventh American Edition (1899), page 696, section 677.

[12] **[Former Procedure]** Prior to 1921 the Treasury held that "transactions in 'futures' unclosed at the end of the taxable year, formed no integral part of the cost of the commodity included in the taxpayer's physical inventory." (C. B. 3, page 66; A. R. M. 100.)

"hedges" in the inventories of dealers in cotton, grain, and similar commodities. The author has contended for many years that such disregard for recognized accounting practice is not in accordance with the law.

Ruling. From its previous opinion[13] the Bureau now finds no cause to deviate and holds it to be self-evident without reference to the legal question involved, that any proposition to add to an inventory the value of a commodity, the title to which is not at the time actually vested in the taxpayer or to deduct from an inventory the value of a commodity, the title to which may or may not be vested in the taxpayer, but which is to be delivered only at some time in the future, cannot by any correct system of reasoning or logic be maintained.

The case now presented for consideration involves quite a different principle and the proposition is not identical with, nor in fact in any degree parallel to the previous decision of the Bureau. In the present decision there is involved firm contracts entered into in good faith for a consideration and enforceable under the law, the value of which (and consequently the profit or loss resulting therefrom) can be absolutely fixed and determined at any minute of any business day. To deny to these contracts at any time during their life Governmental recognition as actual liabilities or actual assets (as the case may be) would be futile, nor could such a contention be sustained in the courts where recognition has heretofore been fully accorded them.

The Bureau accordingly holds that dealers in cotton and grain, and in such other commodities as are dealt in in a similar manner, may for the purpose of determining taxable income, incorporate in their balance sheets at the close of any taxable year, such open "future" contracts to which they are parties as are "hedges" against actual "spot" or cash transactions: *provided,* that no purely speculative transactions in "futures" not off-set by actual "spot" or cash transactions, may be so included or taken into the taxpayer's account in any manner until such transactions are actually closed by liquidation; and *provided further,* that the values of the commodity covered by such open "future" contracts shall not be added to nor deducted from the inventory of the taxpayer. (Special summary of Memorandum No. 135, May 23, 1921, prepared by the Committee on Appeals and Review, for release July 15, 1921.)[14]

It has been held that the ruling made in A. R. M. 135 is applicable to all dealers in commodities "as are dealt in in a

[13] C. B. 3, page 66; A. R. M. 100.

[14] For complete ruling, including extracts from briefs filed see C. B. 5, page 67; A. R. M. 135.

manner similar to that outlined in such ruling," and particularly to millers who hedge future contracts for wheat against unfilled flour sales.[15]

Goods sold for future delivery.—Article 1584[16] provides that goods sold for delivery at fixed prices already agreed upon, and on hand at date of inventory, must be inventoried at cost. If sold at prices which yield a normal profit, the requirement is sound if there is no possibility of cancellation and if the credit of the buyer is beyond question.

When goods for future delivery have been sold at a loss, they should be inventoried at market, as if they were not sold.

The following authoritative statement has been made public by the American Institute of Accountants.[17]

> The treatment of inventories by companies having contracts for sale of goods at prices yielding a profit above cost was considered. It was agreed that where goods have been bought specifically for such contracts, they should be taken at cost even if that be higher than market, both for general accounting and tax purposes. This should apply only if the contracts are enforceable contracts with responsible people—not in cases where enforcement would involve such risk of a bad debt as to be unwise. It was recognized that the question as to applying goods on hand to such contracts where they were not earmarked was difficult, and the firm (of accountants) should not be disposed to question any reasonable course adopted by any client in this matter.

> Ruling. . . . . In the contracts involving the delivery of goods in the future the company at no time makes any particular appropriation of any particular goods to fill any particular order or portion thereof until the time specified for the delivery of the goods to the carrier. At the time of entering into the contract, in a majority of the cases the purchaser gives his promissory note in settlement for the goods. The notes do not bear interest until maturity, and generally the due date of the note is fixed at the time of the delivery of the bulk of the order if that time is determinable at the time of entering into the contract. The nature of the goods is such that they deteriorate rapidly, consequently only such goods are manufactured at any particular time as are necessary to fill and complete shipments

[15] C. B. I-1, page 52; I. T. 1166.
[16] See page 492.
[17] Special Bulletin No. 7, December, 1920.

of orders for delivery at the particular time the goods are manufactured.

Held, that under the provisions of section 213 (a) of the Revenue Act of 1918, the M Company is not required to treat its contracts covering unfilled and undelivered orders for its goods as gross sales for the year in which the order is taken and the contract entered into, but that the sale of the goods can not be properly considered as having taken place until the goods are delivered to the carrier for shipment to the buyer, or in those cases in which the purchaser is to call for the goods at the place of business of the company, until there is a specific identification of the goods manufactured and they are put in a deliverable state. (C. B. 4, page 95; O. D. 826.)

Where no specific goods are appropriated to the contract, but deliveries are made from regular stock, such goods should be inventoried on the basis of cost, or cost or market, whichever is lower, depending on which of these two methods is employed by the taxpayer.

General Basis for Valuation of Inventories

Law. Section 203. **That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.**

Regulation. The Act provides two tests to which each inventory must conform: (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) it must clearly reflect the income. It follows, therefore, that inventory rules can not be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

The basis of valuation most commonly used by business con-

cerns and which meets the requirements of the Revenue Act is (*a*) cost or (*b*) cost or market, whichever is lower.[18] . . . .

In respect to normal goods whichever basis (*a*) or (*b*) is adopted must be applied with reasonable consistency to the entire inventory. Taxpayers were given an option to adopt the basis of either (*a*) cost or (*b*) cost or market, whichever is lower, for their 1920 inventories, and the basis adopted for that year is controlling and a change can now be made only after permission is secured from the Commissioner. Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be either (*a*) the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired, or (*b*) where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred, or sold, calculated upon the basis of the actual cost of the goods acquired during the taxable year (including the inventory at the beginning of the year) the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

Inventories should be recorded in a legible manner, properly computed and summarized, and should be preserved as a part of the accounting record of the taxpayer. The inventories of taxpayers on whatever basis taken will be subject to investigation by the Commissioner, and the taxpayer must satisfy the Commissioner of the correctness of the prices adopted.

The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with these regulations, viz.:

(*a*) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

(*b*) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

(*c*) Omitting portions of the stock on hand.

(*d*) Using a constant price or nominal value for a so-called normal quantity of materials or goods in stock.

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[18] **[Former Procedure]** Cost price was prescribed by the directions printed on the corporation return No. 1031, as revised October, 1916.

For 1917, the methods of (a) cost, or (b) cost or market, whichever is lower, were authorized by T. D. 2609, December 19, 1917.

T. D. 3296, issued March 3, 1922, amended Regulations 45 so as to make the inventory provisions of Regulations 62 in effect retroactive to 1918.

(*e*) Including stock in transit, either shipped to or from the taxpayer, the title of which is not vested in the taxpayer. (Art. 1582.)

The foregoing regulation is an admirable exposition of good accounting practice and is a vast improvement over some of the former regulations dealing with inventories. It will be found that balance sheets properly prepared reflect good accounting practice in the taxpayer's trade or business. The law gives the Commissioner wide discretion in the matter of inventories and it is to be hoped that many of the irritating differences of opinion which grew out of former regulations will disappear.

The five methods which are specifically disapproved are in themselves technical departures from good accounting practice. In practice the necessary writing down of inventory values to meet actual market conditions, adhering strictly to the new regulations, will in many cases produce the same net result as if one or more of the methods disapproved had been used.

Change of basis of valuation.—Early in 1920, the Treasury held:

Ruling. . . . . If inventories have been taken in the past on the basis of cost and the request is now made to change to "cost or market, whichever is lower," the reasons for the request should be carefully scrutinized and the request refused if it appears that the principal reason therefor is to reduce the tax payable for 1919. . . . . (C. B. 2, page 54; A. R. M. 38.)

Later, but prior to T. D. 3108,[19] this position was reconsidered on the ground that in "many instances the taxpayer has had no real election, but has been forced to take his inventory on either basis at cost, since cost was lower than market. . . . ."

Ruling. . . . . The Committee therefore recommends that Memorandum No. 38 be modified to the extent that where it can be shown that market at the close of 1918 and 1919 was above cost the taxpayer may now elect to take his inventory upon a cost or market basis, whichever is lower, provided that such practice is consistently

[19] December, 1920.

adhered to in the future, but that the memorandum in question stand so far as it applies to those cases where there was an opportunity to take inventories at a figure lower than cost because market was lower than cost at the close of 1918 or 1919, and consequently there was a real election to continue upon a cost basis. (Ruling 13-20-804, modified.) (C. B. 3, pages 65, 66; A. R. M. 85.)

Good reasons for the change must be given or permission will be denied.—

Ruling. A taxpayer, which prior to 1920 had based its closing inventory on the basis of cost, but which under the general provisions of T. D. 3108 (C. B. 4, page 49), adopted the basis of "cost or market whichever is lower" for its 1920 closing inventory, will not be permitted to change back to the basis of cost for the year 1921 when the only reason given for such change is that it had heretofore used the cost price basis. (C. B. I-1, page 44; Digest I. T. 1189.)

"Cost or market price" is not illegal.—The regulations quoted above reiterate and amplify the principles originally laid down in T. D. 2609, the legality of which was questioned; but the Attorney General, to whom the question was referred, "advised upon the basis of a decision of the Supreme Court,[20] that the methods of taking inventories authorized by T. D. 2609 are permissible."[21]

Inventories at cost.—

Regulation. Cost means:

(1) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(2) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts, approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

(3) In the case of merchandise produced by the taxpayer since the beginning of the taxable year (*a*) the cost of raw materials and supplies entering into or consumed in connection with the product, (*b*) expenditures for direct labor, (*c*) indirect expenses incident to

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[20] *Doyle v. Mitchell Brothers,* 247 U. S. 179, 38 Sup. Ct. 467, 62 L. Ed. 1054.

[21] 31 Op. A. G. 301; T. D. 2744, July 3, 1918. See page 507.

and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.

(4) In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry. . . . . (Art. 1583.)

Purchase discounts actually earned are treated by some as a financial gain and by others as a reduction of cost.

Rulings. Taxpayers who as a matter of settled practice do not deduct cash discounts from purchases, but who take the merchandise purchased into their inventories at invoice price (less trade or other discounts other than strictly cash discounts), carrying the discounts in a discount account, may not, in valuing their closing inventories for income tax purposes, deduct from the invoice price of the merchandise on hand at the close of the taxable year the average amount of cash discount received on such merchandise; neither may the amount of cash discount earned, to be reported as income, be decreased by an amount representing the estimated cash discount received on merchandise on hand at the close of the year. (C. B. 1, page 56; O. D. 326.)

Held, that a wholesale liquor dealer who, for years prior to 1918, exercised the option of including excise taxes in cost of merchandise in calculating inventory may not amend such inventory and treat such taxes as business expenses for 1918. . . . . (C. B. 4, page 61; A. R. M. 121.)

Allocated cost method permitted.—

Regulation. A taxpayer engaged in mining or manufacturing who by a single process or uniform series of processes derives a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike, and who in conformity to a recognized trade practice allocates an amount of cost to each kind, size, or grade of product which in the aggregate will absorb the total cost of production, may use such allocated cost as a basis for pricing inventories, provided such allocation bears a reasonable relation to the respective selling values of the different kinds of products. (Art. 1587.)

The foregoing regulation is in accord with the law which permits *any* inventory method which accords with good accounting practice. Special procedure has been prescribed in

the case of the tobacco industry, and may be extended to any other industry in which conditions justify a departure from the general rule.

Average cost method permitted—tobacco industry.—

Ruling. . . . . Tobacco companies taking inventory on the monthly average cost method, no method more nearly approaching theoretical accuracy being practically possible, may continue to use such method in reporting for income tax. . . . .

The method followed, as understood by the Committee, is an average cost method and not an average cost or market method. Accordingly, if the market should be below the average cost at the close of a given year, the average cost shall be the basis of valuation and not the lower market price. Companies adopting average-cost methods of inventorying for income-tax purposes should be required to adhere to that method in future years. . . . . (C. B. 2, page 50; A. R. R. 18.)

If average cost represents as nearly as can be determined actual cost, and market prices are lower at the end of any year, taxpayers cannot be denied the right to value inventories at market prices.[22]

Average market price not permitted.[23]—

Ruling. A company taking its inventory upon the basis of the average of the market prices prevailing over a period of years does not conform to the method of computing inventories in accordance with articles 1581-1585, Regulations 45, and it should therefore be required to file amended returns. (C. B. 1, page 55; Digest T. B. M. 31.)

Inventories at market.—

Regulation.[24] Under ordinary circumstances, and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases (*a*) of goods purchased and on hand, and (*b*) of basic

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[22] For illustration of average cost method—lumber manufacturers—see *Income Tax Procedure*, 1922, pages 461-462.

[23] For discussion of farm price method, see Chapter XLIV.

See also "Lumber Costs," by Edmund M. Meyer, *Journal of Accountancy*, August, 1921.

[24] See Chapter XXXIV where claims for shrinkage in inventory losses are discussed.

elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, which goods must be inventoried at cost. Where no open market exists or where quotations are nominal, due to stagnant market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less proper allowance for selling expense, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market. (Art. 1584.)

The foregoing regulation accords with good accounting practice.

The Treasury now recognizes that the current *bid* price may not represent what a purchaser might have to pay if he attempted to buy in quantities; what the taxpayer would probably pay is a much fairer test of the market value than apparent bid prices in abnormal markets.

The foregoing regulations, in recognizing abnormal conditions, throw a considerable amount of responsibility on the good judgment and good faith of the taxpayer.

Probably the most important factor in fixing market prices is quantity.[25] If the quantity on hand is in excess of the reasonable requirements of the taxpayer, the nominal market price for a small quantity usually is not the market price for larger quantities. In a declining market it is proper to assume that replacement market prices for large quantities are considerably below ruling market prices.[26]

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[25] See *Auditing, Theory and Practice,* Vol. I (1921 edition), by R. H. Montgomery, page 127.

[26] See page 499.

At the end of 1920 many users of steel products had placed large orders for steel. When the general price decline came, the demand for their finished product vanished overnight, particularly in the automobile industry, yet the price of forgings and other raw material showed no decline because the steel mills had large accumulated orders on their books. Using the nominal "bid" prices prevailing at the date of the inventory would have compelled these manufacturers to pay taxes at the high rate on enormous inventories which they were not able to liquidate for some very considerable time.

Cost or market to be applied to each item of inventory.—In connection with an interpretation of the terms (a) cost, and (b) cost or market, whichever is lower, questions have arisen as to whether certain items in an inventory may be priced at cost (which is less than market) and other items of exactly the same kind, which cost more, may be reduced to market. For illustration, certain lots of pig iron may have cost $20 per ton. Other lots may have cost $25 and additional lots may have cost $30. When inventory is taken the market price is $25. Where the lots can be readily identified the first lot should be kept at cost, viz., $20 per ton, the second lot should be kept at market, viz., $25 per ton, and the third lot should be marked down to market, viz., $25 per ton.

Article 1582 implies that *in the same inventory* some items may be taken at cost and some (when the market has dropped) at less than cost. No other method would properly interpret the term "cost or market, whichever is lower," nor conform to good accounting practice.

Ruling. This office acknowledges receipt of your letter of September 7, 1921, making inquiry as to whether Article 1582, Regulations 45, 1920 edition, provides for a change in the method of applying the basis of cost or market whichever is lower, in valuing an inventory.

In reply you are informed that the change of wording in Article 1582, Regulations 45, 1920 edition, is not intended to change the former method of applying the basis of cost or market to each item of the inventory. In employing the basis of cost or market whichever

is lower, the lower value of each item listed in the inventory must be placed upon the particular item. You will note that one item may be valued at cost while another may be valued at market. The valuation to be placed on the item is determined by the fact that either cost or market value is the lower. (Letter to Prentice-Hall, Inc., signed by E. H. Batson, Deputy Commissioner, dated September 20, 1921.)

There seems to have been some confusion in the minds of taxpayers as to the practical application of the "cost or market, whichever is lower" method. Ordinarily it is not feasible to segregate or identify the various lots which were sold or still remained in stock. To do so involves a minute segregation of accounts, such as is found in a comprehensive cost system. In the ordinary course the stock purchased first must be assumed to be the stock sold first, and the stock to be inventoried would be that last purchased. The cost of these last lots is compared with the market price, and the lower of the two is taken.

Rulings. Receipt is acknowledged of your letter of February 16, 1922, relative to the manner of valuing goods included in the closing inventory of the taxpayer for the year 1920 and still on hand at the close of the taxable year 1921, the inventories being valued on the basis of cost or market whichever is lower. Inquiry is made relative to the valuation for the purposes of the 1921 closing inventory, of a set of books which cost $10.00 to produce in 1920, the market price of which was $8.00 on December 31, 1920, and $9.00 on December 31, 1921.

. . . .

In the illustration presented by you, the item referred to should be valued at $9.00, as that is stated to be the market value of each set of books at the close of the accounting period for which the inventory is taken, and is lower than the original cost. You are further advised that in determining the gain or loss on an article included in the closing inventory for a particular year and disposed of in a subsequent year, the value at which such article was included in the last inventory should be used as a basis for arriving at such gain or loss. The last inventory will, of course, be the closing inventory of the year preceding the one in which the article is sold.

. . . .

. . . . you are advised that as was stated in letter of March 7, 1922, with respect to the illustration presented by you in letter of February 16, 1922, the item referred to by you should be valued

at $9.00, as that is stated to be the market value of each set of books at the close of the accounting period for which the inventory is taken, and is lower than the original cost. Relative to the first paragraph of Article 1583,[27] Regulations 62, referred to in your letter, you are advised that this paragraph has reference to an inventory valued on the basis of cost and not on the basis of cost or market whichever is lower. Where the inventory is valued at cost and an article which is included in the preceding inventory is still on hand and included in the succeeding inventory, such article should be valued at the same cost price at which it was included in the preceding inventory.

Relative to your contention that a paper profit will be shown by valuing, for the purpose of your 1921 closing inventory, each set of books at $9.00, the market price at the date of inventory, instead of $8.00, the price at which such books were included in your closing inventory for the preceding year, you are advised that in so valuing such goods for the year 1920 you automatically took into account a loss by reason of the decline in value from the original cost, although such loss had not actually been realized by the dispostion of the goods. In valuing an inventory on the basis of cost or market whichever is lower, the inventory value of a particular article can not exceed the cost, and although the value at which the article is included in a particular inventory may exceed the value at which the article was included in the preceding inventory, no profit over and above the original cost will thereby be taken into account. (Extract from letters to Prentice-Hall, Inc., signed by E. H. Batson, Deputy Commissioner, dated March 7 and April 3, 1922.)

. . . . The paragraph in question states that cost means "in the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods." Upon further consideration of the question presented by you, it is the opinion of this office that cost, for the purpose of valuing an inventory, is to be determined in accordance with Article 1583, regardless of whether the basis of cost or cost or market value whichever is lower, is used. Therefore, where an inventory of goods at the close of a taxable year includes merchandise which was on hand at the beginning of the year, the cost thereof, to be compared with market in applying the basis of cost or market whichever is lower, should be the price at which such goods were included in the opening inventory. (Letter to Patterson, Teele and Dennis, signed by Commissioner D. H. Blair, and dated November 4, 1922.)

Net selling prices.—A further recognition by the Treasury that apparent market prices are often not real, particularly

[27] See page 490.

in the case of goods that are shopworn, obsolete, or that have deteriorated from some other cause, is found in the regulations now in force. The author has contended in the past that "for many reasons merchandise may have to be valued below cost; overstock; damage or deterioration; changes in styles and shapes; obsolescence—going out of date; sizes and qualities seldom used; broken lots."[28] The latest regulations give effect to this contention.

REGULATION. . . . . Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less cost of selling whether basis (*a*) or (*b*) is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they should be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offerings of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made. . . . . (Art. 1582.)

The foregoing article assumes that the goods inventoried would not be replaced and that they are worth the gross sales price subsequently realized less expense of selling. It is the most reasonable method of inventorying such goods. It does not, however, give to a new fiscal period any element of profit. If the merchandise is of such a nature that the market price can be obtained, it is more conservative to use market prices than net selling prices.[29]

Obsolete stock may be written down or off.—The principle of cost or market, when applied to inventory items which have become obsolete or nearly so, is feasible. If

[28] *Income Tax Procedure*, 1921, page 349.
[29] See page 493.

there were a reasonable demand for the items they would not be classed as obsolete. If the demand has definitely fallen off or has ceased, the market value has correspondingly declined and such stock may, in accordance with the principle, be written down to its market value or marked off entirely if it has no market value.

In many lines of industry, notably the automobile industry, new designs have rendered obsolete much of the finished goods carried in the inventory. When this is known before the end of the year, the obsolescence is certainly definite and should be reflected in the inventory values.[30]

Are the inventory regulations in accord with accounting procedure?—The regulations quoted are in accord with sound commercial practice, assuming that "market price" will be construed to mean a fair and reasonable price.

Inventories should be valued at "cost or market, whichever is lower," except when trade conditions or long-continued custom calls for a still lower basis.[31] Apparent market prices may not be true market prices. This is particularly the case in a falling market, but may be equally true when a rising market indicates speculative prices arising out of shortages (which may be only temporary). In such cases, goods purchased at the speculative prices may at inventory time appear to be worth cost and the apparent market price may be even higher, but a conservative concern would hesitate before recognizing such values as real. Therefore, no matter how staple or salable the goods may be, if the market price has declined the inventory should be reduced to correspond. As stated in the new regulations, merchandise may for various reasons have to be inventoried below cost.[32]

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[30] For discussion of "marked selling price" valuation applicable to obsolete stock, see page 499.

[31] Art. 1584.

[32] For full discussion of factors which influence inventory valuations, see *Auditing, Theory and Practice*, Vol. I (1921 edition), by R. H. Montgomery, pages 117 to 172.

Portions of inventories usually priced at less than either cost or market.—In some cases it will be necessary to continue to price portions of an inventory at less than either cost or market. Businesses such as those of agricultural implement and automobile manufacturers frequently find that they have on hand large stocks of spare parts which are not worth cost or the nominal market.

As a matter of fact, small quantities may be selling freely and at a very high rate of profit. But inventories must not be taken on the supposition that an entire stock is worth as much proportionately as a small part. A hatter has in stock 100 perfectly good hats. He may sell 50 of them at a good profit. If he then takes stock, and from experience knows that the most the future market will absorb is 40, ordinary business practice requires him to inventory 40 at cost or market, whichever is the lower, or 50 at the same aggregate price, but at a lower unit price. This is not a departure from, but is an adherence to, the principle of inventory valuation which conforms "to the best accounting practice." Future demand is one of the controlling factors in the determination of market prices.

If on December 31, 1922, it were known that the future demand was decreasing, that factor would have its influence on market prices of that date, but no one would be warranted in assuming that further declines would take place thereafter *unless in previous years it had been customary to carry stock at less than cost or the market.* It is obvious that if such a custom were an old one the government might not lose through its continuance, because a change in policy would result in the adjustment of the returns of previous years, which would in most cases leave the net result for 1922 unchanged.

The Treasury, however, has gone on record as being opposed to the so-called "base stock," "minimum" or "cushion" method. As stated by the Treasury:

RULING. . . . . According to the base-stock method of taking inventories a manufacturer or dealer values at the same price year after year the minimum quantity of goods which he must have on hand at all times. . . . . (C. B. 1, page 51; T. B. R. 65.)

In the detailed opinion it was held that:

The base stock method of taking inventories is not warranted by the law or the Regulations.

The Treasury's arguments against this method are:

1. The method has not been widely adopted.

2. To sanction its use would be discriminatory.

3. It is not the "accounting practice" followed by a majority of manufacturers.

4. It assigns profits and losses on the minimum inventory to the year in which such inventory is liquidated, by ignoring sales of individual items in the inventory and treating the minimum inventory as a unit.

5. It disregards gains that may be considered quasi-capital gains and are taxable under American (as distinguished from British) income tax laws.

6. In substance, it results in offsetting an inventory gain of one year against an inventory loss of another.

Income from sales of small quantities which form part of a large lot.—When a stock of materials or goods consists of a number of units, it is sometimes difficult to determine the measure of profit or loss which should be assigned to the disposition of a part of the stock pending the sale of the entire lot. In theory the aggregate of the cost or inventory price can be distributed to each unit and thus the profit or loss on each sale would be easily determined, but in practice it is well known that it may be easy to dispose of part of a large stock whereas the remainder may never be sold.

It is claimed by some that the entire proceeds of first sales should be credited against the entire lot and that no profit should be taken until the purchase or inventory price is exceeded or it is known that it will be exceeded.

In other cases profit or loss is shown in each item as it is sold.

This is one of the questions which must be settled according to good accounting practice, which requires that where unusual conditions obtain, the item should receive special treatment. This, in turn, must be controlled by the good judgment and good faith of those in charge of the business.

The foregoing reasoning is applied to stocks of liquor, since the difficulty of disposing of them has recently increased. The Treasury seems to feel, however, that such stocks have a "market value."

RULING. . . . . The prohibition law, as understood by the Committee, permits the use of distilled liquors and wines in the manufacture of medicines and in the filling of prescriptions for medicinal use. The provision for these legitimate demands, therefore, gives to the goods available to supply them some value, and it is presumed that there can be readily established the market value for the supplying of such demands. It is true that the demand is not sufficient to create a market for all the goods held in stock, and that an attempt to sell for this purpose at one time any very considerable part of the stocks on hand would doubtless flood the market and break it down to a very low figure. In a measure, however, this was true before the enactment of prohibition laws, as the supply of liquor on hand was always in excess of any immediate demand therefor. . . . (C. B. 2, page 53; A. R. M. 33.)

The foregoing ruling is not consistent with the more recent inventory regulations. Quantity on hand is always a factor in determining market prices. An overstock always demands a look into the future and frequently justifies a radical marking down of an inventory to what is believed to be a fair "market" price.

Inventories by retail dry goods and other retail dealers.—Among the specific classes of taxpayers to whom special methods of inventorying have been allowed are "retail merchants." It is noteworthy that the Treasury is recognizing trade practices in various trades and that where they are long established taxpayers are allowed to adhere to them.

Regulation. Retail merchants who employ what is known as the "retail method" of pricing inventories may make their returns upon that basis, provided that the use of such method is designated upon the return, that accurate accounts are kept, and that such method is consistently adhered to unless a change is authorized by the Commissioner. Under this method the goods in the inventory are ordinarily priced at the selling prices, and the total retail value of the goods in each department or of each class of goods is reduced to approximate cost by deducting the percentage which represents the difference between the retail selling value and the purchase price. This percentage is determined by departments of a store or by classes of goods, and should represent as accurately as may be the amounts added to the cost prices of the goods to cover selling and other expenses of doing business and for the margin of profit. In computing the percentage above mentioned, proper adjustment should be made for all mark-ups and mark-downs.

A taxpayer maintaining more than one department in his store or dealing in classes of goods carrying different percentages of gross profit should not use a percentage of profit based upon an average of his entire business, but should compute and use in valuing his inventory the proper percentages for the respective departments or classes of goods. (Art. 1588.)

While this method in the article quoted is limited to "retail merchants," it will be noted from the following letter of the Commissioner that the method will be permitted to those stores which follow essentially the practices of such retail merchants as retail dry goods stores.

Ruling. Reference is made to your letter of January 13, 1921, relative to T. D. 3058, issued August 16, 1920 (Article 1588 of Regulations 45.—Inventories of retail dry goods dealers) asking for further details as to proper procedure within the meaning of the regulations. Your questions are taken up and answered in the order in which you presented them.

1. The use of the retail method is by the decision confined to retail dry goods dealers. Other organizations and individual stores who conduct retail establishments and follow essentially the retail method of dry goods stores, may be allowed this method upon application to the Bureau of Internal Revenue.

2. *The designation of the method as a "cost" method.* It was not intended that the apparent limitation should be inflexible. It is recognized that on a constant or rising market the retail method is approximately a "cost" basis, and that on a falling market it results in a reduction to "cost or market whichever is lower."

3. *Preserving records.* There must be a permanent form of re-

cording by departments, purchases showing the firm name, date of invoice, invoice cost and retail sales, stock, etc. It must be borne in mind that under no circumstances will arbitrary standard percentages of purchase mark-up be allowed in the determination of the "cost" or "cost or market" value of retail inventories; but that such percentages must be the purchase mark-up percentage disclosed by the department records of the fiscal period for which the return is made.

4. *Opening inventory.* In Section "A" the words "the value of all merchandise as received" is inclusive of inventory at the beginning of the period. The purchase mark-up must be computed as follows:

Cost: Inventory at cost at beginning: purchases at cost; transportation.
Retail: Inventory at sales price: purchases at sales price.

5. *Appreciation in retail values of goods on hand.* Within the meaning of the Article, it is proper to include as a part of "original retail sales price" the actual increase in the original sales price which has been brought about by market conditions or by incorrect pricing when the goods were put into stock. For the convenience of the examining officer, a special form should be provided; complete information by items of the increase from the original retail must be shown; reference, if possible, must be made to the original invoice; entry and the reason for the increase freely explained. All such amended retail increases must be approved by the buyer of the department and merchandise manager or other responsible official and they should be so filed that quick reference to them may be made. Entry of such increased retail prices properly belongs in department purchase books, although it may be set up as a separate item in the accumulated records of the department. The same forms that are used to record such price increases should not be used for mark-downs and in no instances will a store be allowed to include as retail increases a mark-up which has been taken as a correction or cancellation of a mark-down; such mark-up must be regarded and treated in all cases as opposite to mark-down.

6. *Proper mark-downs substantiated by record of facts will be permitted.* The decision is not intended to disturb the procedure in stores which have properly handled mark-downs, but instances where arbitrary reductions from retail values have been made because of the desire to provide for depreciation and obsolescence with no actual offering to the public of the goods on which the mark-downs were claimed, cannot be recognized. Under no circumstances will a store be allowed to depreciate its stock in any way except by the offering of it to its customers at such reduced prices. The procedure of stores or period of that year the goods so marked down are in proportion to current sales, stock on hand, to mark-downs of preceding months in regard to mark-downs will be deemed proper if in any fiscal year

of preceding year, or if evidence can be submitted as to market changes which have forced a reduction in retail prices necessary to bring about a parity with the selling price of the same goods which have been purchased or could be purchased at a reduced cost.

In conclusion it should be noted that a store which has employed this retail method in the past, may now specify in the return that such method is used, as a basis of valuing inventories, regardless of the fact that in past years it reported on a "cost" or "cost or market, whichever is lower" basis. However, the use of the retail method will not be recognized unless it has been correctly followed throughout the entire fiscal or calendar year period for which the return is made. (Letter to the National Retail Dry Goods Association, New York, N. Y., signed by Commissioner Wm. M. Williams, and dated January 21, 1921.)

The following ruling appears to permit the use of the ordinary "cost or market, whichever is lower" method, even where the "retail method" is ordinarily employed.

Ruling. . . . . Held, that when a taxpayer uses the "retail method" he may value inventory on the basis of cost or market whichever is lower, provided cost of each item is compared with market value and the lower of the two used as the inventory value. (C. B. I-1, page 44; I. T. 1219.)

To illustrate, assume the following:

Goods cost		$100,000
Mark-up, ⅓ of selling price		50,000
Selling value		$150,000
Goods sold	$50,000	
Mark-downs	20,000	70,000
Inventory at selling value		$80,000

By deducting from the total selling price ($80,000), one-third thereof, or $26,667, the inventory value at cost, $53,333, would be obtained.

Assume further that mark-downs aggregating $20,000 were not enough—that the person responsible had erred as to the prices that could be obtained for the goods, and that the actual "market value" of the inventory, instead of being $53,333, as the result of applying the "retail method," was actually $40,000. Under such circumstances income could be further reduced $13,333.

Market value of goods in process and finished goods.—One of the most difficult problems of manufacturers arises from work in process and finished goods.

This question is of major importance in a time of demoralized markets.

The following comparison illustrates the problem:

FINISHED GOODS

	Actual Cost	Replacement Cost, i. e., Actual Market
Material	$100	$ 50
Labor	200	120
Overhead	200	200
Totals	$500	$370

This assumes that material has declined 50 per cent and labor 40 per cent. Overhead may remain at the same figure or be changed.

Work in process should be valued by applying the ratios of decline thus obtained to the *actual* cost of the inventory of goods in process. Different stages of completion will require adjustment.

The Treasury permits the foregoing adjustment of material prices and also permits the replacement basis in labor and expense items. The physical property which is inventoried is goods in process (or finished goods). If goods and wages have declined, the product of goods and wages declines in value. An inventory is not at "market" unless it is adjusted to what is practically a replacement basis as at the date of the inventory.

In addition to the present cost of replacement, consideration should be given to the selling prices in effect for such goods, goods in process and finished goods at the present time, which for inventory purposes should be valued at not more than their selling value less shipping or other costs yet to be incurred.

The selling price of goods is a measure of the demand for them and a supplemental indication of their present market

value, even when market value is considered from a replacement rather than from a sales point of view.

Notice to Treasury of method adopted.—When the peculiar conditions of any business make a literal compliance with the regulations difficult or impossible, it is advisable to attach a statement to the return to the effect that inventories were taken at what the taxpayer believed to be market values, but that owing to the difficulty of ascertaining trustworthy market values the taxpayer reserves the right to amend the return if it subsequently be found that the information was inaccurate.

Dealers in securities may use inventory method.[33]—

Regulation. A dealer in securities who in his books of account regularly inventories unsold securities on hand either (*a*) at cost or (*b*) at cost or market, whichever is lower, or (*c*) at market value, may make his return upon the basis upon which his accounts are kept; provided that a description of the method employed shall be included in or attached to the return, that all the securities must be inventoried by the same method, and that such method must be adhered to in subsequent years, unless another be authorized by the Commissioner. For the purpose of this rule a dealer in securities is a merchant of securities, whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. If such business is simply a branch of the activities carried on by such person,[34] the securities inventoried as here provided may include only those held for purposes of resale and not for investment. Taxpayers who buy and sell or hold securities for investment or speculation, and not in the course of an established business, and officers of corporations and members of partnerships, who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule. A dealer in securities is not entitled to the benefits

[33] [Former Procedure] Dealers in securities were included in the provision entitling taxpayers to adopt "cost or market, whichever is lower" as a basis for 1920 inventories. (C. B. 4, page 52; Mim. 2703.)

[34] Banks and other institutions having established departments for the merchandising of securities. National banks can inventory bonds but not stocks (I-35-479; I. T. 1429).

of section 206[35] with reference to the gain from the sale of securities. (Art. 1585.)

Many "dealers in securities" are partnerships. Securities which are really investments may have been carried in the inventory. If it is desired to secure the benefits of section 206 (capital gains), there seems to be no reason why such securities should not be taken out of the inventory and carried as investments, if they are such in fact.

Prior to issuance of T. D. 2609 (December 19, 1917), those who dealt in things other than "materials, supplies and merchandise" were not permitted by the regulations to calculate their losses or gains by the usual methods, but were required to keep an accurate record of each item (even if these items ran up into the tens of thousands), its cost and the date and its sale and the date (even though many years subsequent). Most taxpayers were unable to comply with these requirements and therefore their modification became necessary. The Treasury announced that the authority for T. D. 2609 and for the general extension of the inventory method to dealers in securities was an opinion of the Attorney General,[36] viz.:

RULING. The Attorney-General has advised upon the basis of a recent decision of the Supreme Court [*Doyle v. Mitchell Brothers,* decided May 20 last (247 U. S. 179)] that the methods of taking inventories authorized by T. D. 2609 are permissible. That decision, supplemented by the last paragraph of T. D. 2649 defining "a dealer in securities," therefore continues to stand as a regulation of the Department. (T. D. 2744, July 3, 1918.)

T. D. 2649 (January 30, 1918) agrees substantially with article 1585 as regards the definition of a "dealer in securities."

Since the case of *Doyle v. Mitchell,*[37] relied upon by the Attorney General, arose under the 1909 law, and since all Supreme Court interpretations of a revenue law are retroactive to the date of the law, it follows that dealers in securities have

[35] Section 206 refers to capital gains. See Chapter XXII.
[36] 31 Op. A. G. 301.
[37] 247 U. S. 179, 38 Sup. Ct. 467, 62 L. Ed. 1054.

had full power to inventory their securities under all income tax laws since 1909.

The privilege, extended to taxpayers by article 1582 (as amended in December, 1920, by T. D. 3108), of changing from the "cost" basis of valuation to "cost or market," is applicable to dealers in securities.[38] However, a bond dealer who in past years failed to inventory unsold securities at cost or market, whichever is lower, is not permitted to file amended returns on such basis. (Letter to Blyth, Witter & Co., dated October 5, 1922.)

Who may or may not use inventories is clearly indicated, in so far as the Treasury is concerned, by reference to T. D. 2649, referred to above. "An individual, partnership, or corporation, with an established place of business and whose principal business is the purchase of securities, and their resale to customers," implies a general definition. For "securities" substitute merchandise, stock-in-trade generally, or any other commodity forming the essential productive factors in the principal business of the taxpayer, and those commodities are subject to the process of inventorying. The test is legitimate dealing and manufacturing as against spasmodic or "on-the-side" dealing.

There is not much difference between a "dealer" who buys and sells securities and a "speculator" or an investor who buys and sells securities. In many cases taxpayers who claimed that they were "dealers" and who were denied the classification by the Treasury, will now benefit by the capital gains privilege.

RULING. . . . . Recommended, that A be classed as a dealer in securities and permitted to use inventories in computing the amount of his taxable net income. The fact that he made the greater portion of his purchases and sales through the agency of the brokerage firm of which he was a member and did not make direct purchases and direct sales to customers from a stock on hand should not, in itself, preclude his classification as a dealer in securities. . . . . (C. B. I-1, page 225; Digest A. R. R. 755.)

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[38] C. B. 4, page 52; Mim. 2703.

INVENTORY METHOD—WHEN APPLICABLE TO "SHORT SALES."—

RULING. Where a taxpayer has "borrowed" stock in order to make a "short sale" the gain or loss arising from such transaction can not be accrued upon the books of the taxpayer at the close of his taxable year by treating as an offsetting obligation the market value of the stock sold "short" as of that date; the gain or loss is determined when the amount of stock sold "short" is repurchased for return to the lender and the transaction closed. . . . . (C. B. 1, page 60; S. 1179.)

The Treasury holds that "the short sale dealer in open short sales, having no stock in his possession to which he has title, consequently has no stock which he can inventory."

When applied to one who is not a dealer in securities the ruling is sound, but there is no good reason why a dealer in securities should not inventory all his trades, at least to the same extent as is permitted in the case of "hedges." (See page 484. The case is not analogous to dealing in futures or to the forward business of dealers in merchandise. Short sales are not usually made as "hedges" but in the ordinary course of business as individual transactions. The dealer does have physical property to inventory, viz., the cash proceeds of the sale, but is really inventorying liabilities. The cash proceeds are worth more or less than their face value, depending on fluctuations in the price of the stock or other property which must be replaced in kind. Therefore the liability must be increased or decreased at inventory time, otherwise the accounts will not reflect the results of the dealer's business on an accrual basis.

The author is of the opinion that a dealer in securities should be permitted to inventory short sales on the basis of the short selling price or cover price, whichever is higher.

The inventory method is supposed to make unnecessary the closing of trades to establish closed transactions. What can be done indirectly should be permitted if done directly. A dealer can readily cover all his short sales before the end of the year and arrange to resell the same or similar classes

of stocks, etc., immediately thereafter, but he should not be required to go through a foolish form if the inventory regulations can provide a more reasonable method.

Returns of dealers in securities.—In preparing returns on form 1040, the taxpayer who has qualified as a dealer in securities is not required to enter the items of his business in schedule D,[39] but should use schedule B. On line 1 of schedule B there should be entered the sales price of all securities sold, and on line 4 there should be entered the cost price of securities purchased. When the dealer has kept his books on an accrual basis and has taken inventories, lines 6 and 8 should be used to record the inventories at the beginning and end of the year. If it is not feasible for a dealer in securities to enter the gross sales price in line 1, because his books show only gross profits, he should then enter the item of gross profits on line 1 and not attempt to set up the cost of securities held on line 4. This method is permissible because it accords with accepted accounting principles.

But schedule B is not intended to be used by those who are not dealers in securities. Speculators or investors who may carry on many hundreds of transactions during the year must either qualify as dealers in securities or they must report under schedule D. It has been urged that an active trader cannot readily prepare schedules which show the sales price and cost of all securities dealt in. If such trader keeps books showing the details of each transaction and if he keeps an account showing the gross profit or gross loss on each transaction, it may be permissible to use such totals in schedule D with an explanation that those figures agree exactly with the regular books of accounts kept by the taxpayer and open to the revenue agents. On the other hand, if such taxpayer does not keep regular sets of books which can readily be verified, the Treasury is fully justified in requiring the detail of every transaction during the taxable year. If some such compilation is not

[39] All references in this chapter are to 1921 forms.

made, the taxpayer himself does not know what his profits or losses have been and, if a compilation is made, there is no reason why a copy of it should not be attached to form 1040 in support of schedule D totals.

INVENTORIES OF SECURITIES BY A BANK MAINTAINING A DEPARTMENT FOR DEALING THEREIN.—

RULING. Reference is made to your letter of May 26, 1919, wherein you ask whether a bank that maintains a branch for the purpose of buying and selling securities has the full status of a recognized dealer in securities.

In reply, you are advised that a bank or other institution having a regularly established department for the merchandising of securities, even though that department is subordinate in importance to other departments, is entitled to the same benefit of using the basis provided for in Article 1585 of inventorying securities acquired and held for resale, as one who is solely a dealer in securities.

In so far as the bank or other institution carry on, with an established place of business a department for the merchandising of securities, it is in respect of such department treated in the same way as any other security merchant. It should be noted, however, that the method of inventorying provided for in Article 1585 has no application and can not be extended to taxpayers simply buying and selling securities for investment or speculation. (Letter to The Corporation Trust Company, signed by Commissioner Daniel C. Roper, dated June 28, 1919.)

The above ruling cannot be applied to stocks held by national banks, as under section 5736, Revised Statutes, such banks are not permitted to deal in stocks. (I-35-479; I. T. 1429.)

Method of valuing inventories when a partnership is succeeded by a corporation.—The question arises as to how an opening inventory should be taken when a corporation succeeds a partnership, the latter having taken its closing inventory at cost, and the market value now being greater than cost.

If the transfer constitutes a closed transaction (and the partners have paid a tax on the appreciation), the opening inventory of the corporation for tax purposes would be the increased value. If the transfer is a continuing transaction, the basis used by the partnership should be continued.

Under the 1921 law,[40] however, such a transfer would not be a closed transaction if the control of the corporation is in the former partners and "the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer." It would appear that, on the one hand, the partners need not pay a tax on such appreciation at the time of the transfer, and that, on the other hand, the corporation may take up the inventory at its present value as the corporation is a separate entity and therefore may properly value any property acquired by it at the value it had at time of acquisition and for which its securities are issued.[41]

At first glance it might appear that some income is escaping taxation but this is more apparent than real. The corporation as such pays no tax on the appreciation, as it occurred prior to its acquisition of the property. The members of the former partnership, however, would pay on the appreciation if, as, and when realized by the sale of their holdings of the corporation's stock. Under the 1921 law[42] their investment in the corporation's stock is in such a case deemed to be the same as their investment in the partnership which had valued the inventory at cost.

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[40] Section 202 (c-3). For full discussion of valuation of assets in reorganizations, see Chapters XXI and XXII.

[41] For further discussion see Chapter XXIX and (as regards the basis for depreciation allowance) Chapter XXXVI.

[42] Section 202 (d).

CHAPTER XX

INCOME FROM SALE OF PROPERTY ON THE INSTALMENT PLAN

The 1921 law provides that the profit arising from sales of property on the instalment plan may be postponed to the period of collection in cash, thus differing from the usual method of accounting for profits arising from other credit sales.[1]

LAW. Section. 202. . . . . **(f) Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.**

Generally speaking, the regulations consider sales to be on the instalment basis when less than 25 per cent of the purchase consideration passes to the vendor at the time the sale is effected, and when the balance of the consideration is payable in specific instalments. Such a condition obtains whether the title rests with the vendor until purchase is completed, whether the title passes to the vendee under a lien agreement, whether the title is reconveyed to vendor by a chattel mortgage, or whether title is conveyed to trustees pending performance of contract. In some states (Illinois, Louisiana, Michigan, and Pennsylvania) a conditional sale contract is not valid as against third parties, and a form of lease is used.[2]

REGULATION. Dealers in personal property ordinarily sell either for cash or on the personal credit of the buyer or on the installment plan. Occasionally a fourth type of sale is met with, in which the buyer makes an initial payment of such a substantial nature (for

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[1] Under T. D. 3082, October 20, 1920, amending Article 42 of Regulations 45, the Treasury made it possible for instalment dealers, under the 1918 law, to report only profits realized in cash collections.

[2] *Instalment Sales and Collections,* by Bryant W. Griffin (1922), page 117.

example, a payment of more than 25 per cent) that the sale, though involving deferred payments, is not one on the installment plan. Dealers in personal property who sell on the installment plan usually adopt one of four ways of protecting themselves in case of default: (a) through an agreement that title is to remain in the seller until the buyer has completely performed his part of the transaction; (b) by a form of contract in which title is conveyed to the purchaser immediately, but subject to a lien for the unpaid portion of the purchase price; (c) by a present transfer of title to the purchaser, who at the same time executes a reconveyance in the form of a chattel mortgage to the seller; or (d) by conveyance to a trustee pending performance of the contract and subject to its provisions. The general purpose and effect being the same in all of these plans, it is desirable that a uniformly applicable rule be established.

The rule prescribed is that in the sale or contract for sale of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, the income to be returned by the vendor will be that proportion of each installment payment which the gross profit to be realized when the property is paid for bears to the gross contract price. Such income may be ascertained by taking as profit that proportion of the total cash collections received in the taxable year from installments sales (such collections being allocated to the year against the sales of which they apply), which the annual gross profit to be realized on the total installment sales made during each year bears to the gross contract price of all such sales made during that respective year. In any case where the gross profit to be realized on a sale or contract for sale of personal property has been reported as income for the year in which the transaction occurred, and a change is made to the installment plan of computing net income, no part of any installment payment received subsequent to the change, representing income previously reported on account of such transaction, should be reported as income for the year in which the installment payment is received; the intent and purpose of this provision is that where the entire profit from installment sales has been included in gross income for the year in which the sale was made, no part of the installment payments received subsequently on account of such previous sales shall again be subject to tax for the year or years in which received. Where the taxpayer makes a change to this method of computing net income his balance sheet should be adjusted conformably. If for any reason the vendee defaults in any of his installment payments and the vendor repossesses the property, the entire amount received on installment payments, less the profits already returned, will be income of the vendor for the year in which the property was repossessed, and the property repossessed must be included in the inventory at its original cost to himself, less proper allowance for damage and use, if any.

If the vendor chooses as a matter of consistent practice to treat the obligations of purchasers as the equivalent of cash, such a course is permissible. (Art. 42.)

When can sales of personal property be deemed to be on the instalment plan?—The growth of the instalment business in recent years, and the special method of reporting income allowed such businesses by the Treasury, has made the matter of classification of prime importance.[3]

Stock sold with 10 per cent cash payment was held to be an instalment sale.[4] In another case, where the cash payment down was 20 per cent, the sale was held to be the equivalent of cash.[5] If the deferred payments (80 per cent) are not *in fact* the equivalent of cash, no tax can be imposed. Under the law no income arises until the *actual* equivalent of cash is realized. Many deferred payments are not discountable on any reasonable basis. In such cases the following ruling governs.

RULING. In the case of sales of personal property where substantial initial payments are made (more than 25 per cent of sale price), obligations of the purchasers need not be regarded as the equivalent of cash if it is shown clearly that such obligations, even though represented by notes or other paper in negotiable form, can not be discounted or otherwise converted into cash without material loss because of lack of credit on the part of the buyer and the nature of the property involved. In such cases profit may be reported as provided for sales on the installment plan. . . . . (C. B. 3, page 107; Digest O. D. 715.)

The foregoing is sound and in strict accord with the law.

VALUE OF SECURITY NO CRITERION.—

RULING. Unless sales of personal property involving deferred payments are properly classifiable as installment sales, a taxpayer will be required to include as income all accrued accounts at their face

[3] "Pianos, talking machines, diamonds, furs, clothes, automobiles, electrical household goods, all types of machinery and equipment, stocks and bonds, cooperative apartments—and even charities, can be arranged on the instalment plan." E. M. Skinner, *Credits and Collections.*

[4] C. B. 1, page 75; O. D. 134.

[5] C. B. 1, page 75; O. D. 290.

value regardless of the market value of the evidence of indebtedness given to secure the unpaid accounts. (C. B. I-1, page 76; I. T. 1191.)

The foregoing would probably apply to automobiles sold on deferred payments where the first payments are so large as to take such sales out of the instalment class.

Amended returns not always permitted.—Where a taxpayer had filed returns for 1917 to 1920 inclusive, treating its sales as the equivalent of cash, it was denied application to file amended returns, for the same years, on the instalment basis.[6]

The circumstances of any one case may justify the Commissioner in refusing to accept amended returns. In general, however, the privileges extended to certain taxpayers cannot be withheld from others. Taxpayers cannot be deprived of a right to change their methods of reporting merely because the change results in reduced taxes. The courts have sustained and will sustain all legal devices which result in a saving of taxes.[7]

Method of computing taxable profit by instalment houses.—The detailed procedure outlined in the following ruling serves to give effect to two principal changes in the Treasury's former requirements.[8]

First. Any collections applicable to instalment sales already reported as income are credited to accounts receivable. No part of such items is used in computing realized profits for the taxable year. This avoids double taxation.

Second. Collections as made are segregated according to the years in which the sales were made. Segregation is also made in the books for each year of—

(a) Sales
(b) Gross profit (unrealized)

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[6] C. B. I-1, page 49; I. T. 1190.
[7] *Weeks v. Sibley*, 269 Fed. 155.
[8] See *Income Tax Procedure*, 1920, pages 309-314.

Ratio of (b) for each year to (a) for each year for which cash is collected in current year, applied to the collections in current year, gives income to be reported as realized profits of current year.

To illustrate, assume:

	Collections made during 1922	(a) Instalment sales contracts (Sales made during respective years)	Goods sold in respective years (cost value)	(b) Unrealized profits on instalment sales contracts	Per cent gross profit
Applicable to 1921	$2,000	$30,000	$24,000	$6,000	20%
Applicable to 1922	8,000	50,000	37,500	12,500	25%
	$10,000	$80,000	$61,500	$18,500	

The problem is to compute the realized profits. The ruling says that such profits should be computed by taking the same percentage of the cash collections made during the taxable year on account of instalment sales contracts of either that or prior years, as the total unrealized profits on instalment sales contracts for the year against which the collection applies, bear to the total instalment sales made during that respective year.

Applying the gross profit for each year to the collections applicable to the respective years, we have:

1921, 20 per cent of $2,000 =	$ 400
1922, 25 per cent of $8,000 =	2,000
Realized profits for 1922	$2,400

RULINGS. The procedure outlined in T. B. R. 24[9] has been reconsidered and as a result of such reconsideration the following has been adopted where a taxpayer engaged in merchandising upon the installment plan has heretofore made returns upon the basis of treating the profit upon installment sales as realized as at the date of sale and now wishes to change to the basis of reporting the profit as being realized as at the date of collection of the outstanding accounts.

1. In accordance with the provisions of article 42 (as amended)

[9] Under this ruling, when a change was made in the instalment method, cash collections applying to sales already reported were included in the new computation.

of Regulations 45, the balance sheet as at the beginning of the taxable year, which shall be filed as a part of the return, shall carry the installment sales contracts unliquidated and remaining in force as at the date that this system of accounting is adopted and made effective by the taxpayer, as accounts receivable, such unliquidated installment sales contracts having been inventoried and determined as at that date. Cash collections on account of such contracts will be credited directly to such accounts receivable and no part of such collections will be included in computing realized profits for the taxable year.

2. As from the beginning of the taxable year, the following accounts should be set up:

(a) *Goods purchased,* which will be charged with the amount of inventory of the goods on hand at the beginning of the taxable year and with the expenditures for goods purchased during the year.

(b) *Goods sold* (cost value), which will be credited with the cost value of all goods sold during the year.

(c) *Installment sales contracts* (year date), which will be charged only with the amount of installment sales contracts made during the year specified. This account for each year will be credited with all cash collected during that year, or in subsequent years, upon installment sales contracts *for that year only,* and with the unpaid installments of defaulted or canceled contracts for that year.

(d) *Unrealized gross profits on installment sales contracts* (year date), which will be credited only with the amount of unrealized gross profits upon installment sales contracts made during the year specified. This amount will be the total of the installment sales contracts for that year reduced by the cost or inventory value (as carried in account (a) (goods purchased), of the actual goods sold and covered by the contracts; the balance remaining being the amount of the unrealized gross profits. The proforma monthly (or annual) journal entry would be:

	Dr.	Cr.
Installment sales contracts (year date)......	$......	
To goods sold (cost value)......................		$......
Unrealized gross profits on installment sales contracts (year date)		$......

(e) *Realized profits on installment sales contracts,* which will be credited from month to month (or at the end of the year), with the profits realized by cash collections upon all installment sales contracts of any year. Such profits should be computed by taking the same percentage of the cash collections made during the taxable year on account of installment sales contracts of either that or prior years, as the total unrealized profits on installment sales contracts for the year against which the collection applies, bear to the total installment sales made during that respective year. Corresponding debits should be made to *unrealized gross profits on installment sales con-*

tracts for the year affected by such collections. If adjustments to any or all of these various accounts become necessary in order that it or they may accurately reflect the facts, such adjustments may be made either monthly or as at the end of the taxable year.

It is believed that sufficient has been said above to indicate the use that is to be made of these special accounts and it is not necessary to discuss any of the other accounts which would normally be maintained.

It will be noted that the foregoing plan which will be permitted upon an explicit statement of facts made to the Commissioner of Internal Revenue by a taxpayer engaged in merchandising upon the installment plan is not a change from an accrual basis to a cash received and paid basis. In the opinion of this office, the income of a merchandising concern can not be correctly reflected upon the latter basis, as the use of inventories is absolutely essential. The plan herein outlined is, therefore, merely such a modification or adaptation of the ordinary accrual method of accounting as in the opinion of this office will enable the accounts of the taxpayer clearly to reflect his net income. Where in the past another method has been used that has failed to reflect the taxpayer's net income an amended return or returns for such year may be made.

In cases where the taxpayer has in the past exercised the option of reporting the profit as realized as at the date of sale and now wishes to change to a basis of reporting the profit as realized as at the date of collection of the outstanding installments, either of which method is allowable under article 42 of Regulations 45, amended returns for years prior to the date that the above outlined system of accounting is adopted and made effective by the taxpayer, will not be required or allowed unless in the opinion of the Commissioner such former method has failed to reflect the net income.[10] (C. B. 3, page 105; O. D. 623.)

If books have been so kept that the cost of each article sold was not shown, gross profit may be determined by taking the average percentage of gross profit on gross sales. If several different lines of merchandise are handled, on which the average percentages of profit differ, the gross profit on total sales of each different class of merchandise should be computed separately. (C. B. 1, page 75; O. D. 25.)

Where a taxpayer is engaged in business making cash, personal credit, and installment sales, the percentage of gross profit to be reported on the installment sales, as provided in article 42 of Regulations 45, is the percentage of gross profit on all sales made during the year in which the installment sale was made, regardless of whether

[10] See page 516 as to amended returns.

[Former Procedure] As to computation of invested capital, see O. D. 793, *Income Tax Procedure*, 1922, page 494, and I-28-405; I. T. 1391.

they were cash, personal credit, or installment sales. (C. B. 5, page 89; Digest O. D. 1107.)

The two preceding rulings are confusing. In O. D. 25 taxpayers are required to make separate computations where the percentage of gross profit on different classes of goods sold on the instalment plan differs materially, whereas in O. D. 1107 taxpayers are required to compute gross profit on all classes of sales.

In the case of instalment houses which have adequate cost records, the latter ruling does not give accurate results and is contrary to the principle laid down in article 42 of Regulation 62, that the income "may be ascertained by taking as profit that proportion of the total cash collections received in the taxable year from instalment sales . . . . which the annual gross profit to be realized on the total instalment sales made during each year bears to the gross contract price of all such sales made during that respective year." As a practical matter it may apply to a concern which can not segregate the cost of items sold on the instalment basis from other sales.

Application of instalment payments.—Since collections made in one year may apply to sales made in different years, each showing a different rate of gross profit, the following rules for applying the cash payments made by customers are important in determining the proportion of such payments to be reported as income.

Rulings. When income from sales of personal property on the installment plan is reported as provided in article 42 of Regulations 45, the payments made by a purchaser having several accounts should be allocated to the particular account or accounts to which under the terms of the contracts of sale such payments are to be applied. (C. B. 5, page 88; Digest O. D. 1045.)

In cases of continuous accounts covering sales of personal property, the income from which is reported on the installment plan as provided in Treasury Decision 3082, the cash payments received should be allocated in accordance with the generally recognized principle of law governing such cases, that is, that failing application by the

vendee, the cash payments should be applied to the earliest items of the account. (C. B. 4, page 88; Digest O. D. 815.)

Computation of bad debts in case of instalment sales.—

RULING. The amount to be deducted from gross income as a bad debt in cases of sales of personal property on the installment plan in which the unpaid installment obligations of the purchaser become worthless and are charged off and the property is not recovered by the vendor is such proportion of the defaulted payments as represents the capital investment, that is, the cost of the goods sold, and this amount must be deducted for the year in which the default occurred.

Let it be assumed that the taxpayer's installment sales (contracts) for the year 1919 were $300,000 and that the cost of the goods sold and covered by such contracts was $100,000; then the unrealized gross profits would be $200,000 and the rate of profit for that year would be established at 66⅔ per cent.

Let it be assumed, further, that during the years 1919 and 1920 the cash collections on account of such contracts were $266,700; then the entries covering these transactions would be as follows:

Installments sales contracts, 1919		$300,000	
To goods sold (cost value)			$100,000
To unrealized gross profits on installment sales contracts, 1919			200,000
Rate of gross profit—⅔ or 66⅔ per cent.			
Unrealized gross profits on installment sales contracts, 1919		177,800	
To realized profits on installment sales contracts			177,800
Cash collections during 1919 and 1920 for account of 1919	$266,700		
⅔ thereof	177,800		

At the close of 1920 the accounts, as affected by the above transactions, would stand as below:

DEBITS		CREDITS	
Cash	$266,700	Goods sold (cost value)	$100,000
Installment sales contracts, 1919	33,300	Unrealized gross profits, etc.	22,200
		Realized profits, etc.	177,800
	$300,000		$300,000

Of the above balance of $33,300 to the debit of installment sales contracts, two-thirds, or $22,200 (shown as a balance to the credit of unrealized gross profits), is to be accounted for and taxed as profit as, when, and if collected. The remaining one-third is the capital investment representing the cost of goods sold.

But let it be assumed that the whole or any part of the balance of the installment sales contracts, amounting to $33,300, was defaulted in

1919 or at any later time; then the question arises: How should the loss occasioned by such defaults be treated for purposes of determining the income and excess profits tax?

The answer is that the proper portion (two-thirds in this case) of the amount of the defaulted payments should be charged against the unrealized profits and the balance (in this case one-third), representing the cost of the goods sold, should be allowed to the taxpayer as a deduction for losses actually sustained during the taxable year.

This method of treatment should be followed whether the goods are or are not recovered. If the goods are not recovered, it correctly reflects the facts without further entries upon the books. If the goods are recovered, their fair market value at the time of recovery should be credited as realized profits for that year, with a corresponding debit to the account of goods purchased. The difference (debit balance) between the two accounts of goods purchased and goods sold should reflect the value of the physical inventory at any given date. (C. B. 4, page 86; O. D. 792.)

Reserves for unearned interest, collection expenses, etc., good accounting practice.—

RULINGS. A taxpayer who sells merchandise on the installment plan may not allocate the expenses incident to producing the income to the year in which the profits on the sale of the goods are realized, but should deduct such expenses in his income-tax return as for the year in which incurred and paid or accrued. (C. B. 4, page 123; O. D. 844.)

Deductions by way of losses or business expenses properly assignable for income tax purposes to profits made in 1920 should be applied against all the profits for that year, including profits returnable in that year on installment sales made in previous years. (C. B. I-1, page 77; Digest I. T. 1227.)

When goods are sold on the instalment plan there is included in the sales price an adequate allowance for bad debts, for the costs of collection, interest and other carrying charges. No specific segregation of the selling price is made, but the items are there nevertheless. There can be no net income until provision is made for costs and expenses. Usually collection and similar expenses are relatively small, but in the instalment business such expenses are high. At the end of each accounting period (or oftener), if accounts are kept on the accrual basis, there should be taken out of gross sales on the instalment plan

such part thereof as may be said to represent the actual cost of carrying and collecting the accounts. If the future costs and charges can be segregated with reasonable accuracy into interest, collection charges, and similar expenses, the separation should be made.

It is somewhat doubtful whether reserves of this kind were allowable deductions heretofore, but since the 1918 and 1921 laws call for the use of the best accounting practice in each trade, there should be no question about the propriety of setting up such reserve accounts to provide for interest and expenses charged to customers, but not collected from the customers and not yet expended for these purposes. When returns are made on the cash basis now permitted, these reserves cannot be claimed as deductions.

Sales of leaseholds—capital gain.—A sale of leasehold interest was made prior to December 31, 1921, payments to be made in instalments. The taxpayer, in reporting the profit in each instalment payment after 1921, was denied the benefit of the capital gains provision (section 206) presumably on the theory that the profit had been realized prior to December 31, 1921.[11] Such a theory, however, is in conflict with article 42, Regulations 62, which presumes that the profit is not realized until cash collection has been made.

Payment in used cars.—

RULING. A dealer in automobiles who takes used machines as part payment on sales of new cars is required to report the entire profits realized on the new cars for the year in which received regardless of the fact that part of the payments received are in the form of used machines. The fair market value of the used cars taken as part payment is deemed to be the value at which they were taken in on the sales.

In case the used cars are later sold, the basis for determining gain or loss will be the value placed on them for income tax purposes when received, or if inventories are employed and the cars were on hand at the beginning of the taxable year in which sold, the value at which

[11] C. B. I-1, page 193; I. T. 1302.

they were included in the inventory at that date. (C. B. 4, page 31; O. D. 782.)

Under the 1921 law the term "readily marketable" would be substituted for the words "fair market value." It is probable that in the automobile trade the former term is more acceptable.

Income from the sale of real estate on the instalment plan.—

Regulation. Deferred payment sales of real estate ordinarily fall into two classes when considered with respect to the terms of sale, as follows:

(1) Installment transactions, in which the initial payment is relatively small (generally less than one-fourth of the purchase price) and the deferred payments usually numerous and of small amount. They include (*a*) sales where there is immediate transfer of title when a small initial payment is made, the seller being protected by a mortgage or other lien as to deferred payments, and (*b*) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the agreed installments have been paid.

(2) Deferred payment sales not on the installment plan, in which there is a substantial initial payment (ordinarily not less than one-fourth of the purchase price), deferred payments being secured by a mortgage or other lien. Such sales are distinguished from sales on the installment plan by the substantial character of the initial payment and also usually by a relatively small number of deferred payments.

In determining how these classes shall be treated in levying the income tax, the question in each case is whether the income to be reported for taxation shall be based only on amounts actually received in a taxing year, or on the entire consideration made up in part of agreements to pay in the future. (Art. 44.)

When obligations of purchasers are not the equivalent of cash.—

Regulation. In the two kinds of transactions included in class (1) in the foregoing article, installment obligations assumed by the buyer are not ordinarily to be regarded as having a readily realizable market value,[12] and the vendor may report as his income from such

[12] **[Former Procedure]** Permission to calculate a proportion only of instalments received as realized income was conditioned upon "title remaining in the vendor until fully paid for." (Reg. 33, 1918, Art. 117.)

transactions in any year that proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price. If the return is made on this basis and the vendor repossesses the property after default by the buyer, retaining the previous payments, the entire amount of such payments, less the profit previously returned, will be income to the vendor and will be so returned for the year in which the property was repossessed, and the property repossessed must be included in the inventory[13] at its original cost to himself (less any depreciation as defined in articles 161 and 162). If the taxpayer chooses as a matter of settled practice consistently followed to treat the obligations of the purchaser as having a readily realizable market value and to report the profit derived from the entire consideration, cash and deferred payments, as income for the year when the sale is made, this is permissible. If so treated the rule prescribed in article 46 will apply.[14] (Art. 45.)

RULING. . . . . In February, 1917, A purchased land and improvements for a consideration of $46x$ dollars. On September —, 1917, an agreement for the sale of the property was entered into between A and his wife, parties of the first part, and B, party of the second part, for a consideration of $70x$ dollars, payable as follows:

$\frac{1}{4}x$	dollars cash, receipt of which is acknowledged,	
$9\frac{3}{4}x$	dollars cash, to be paid on or before	November —, 1917,
$3\frac{3}{4}x$	" " " " " "	December —, 1919,
$3\frac{3}{4}x$	" " " " " "	December —, 1920,
$3\frac{3}{4}x$	" " " " " "	December —, 1921,
$3\frac{3}{4}x$	" " " " " "	December —, 1922,
$3x$	" " " " " "	December —, 1923,

and the balance thereof, to wit: The sum of $42x$ dollars to be paid on or before the —— day of June, 1927, in accordance with the *note* and mortgage executed by the parties of the first part to C, which mortgage is of record, all deferred payments to draw interest at y per cent per annum, interest payable annually, and the party of the second part reserves the right to pay said sums at the due date thereof or any part thereof in multiples of $100 at any time, and upon receipt of the payment of any such sum, interest on such sums so paid shall thereupon cease. . . . .

In determining the amount of the initial payment it has been the practice to consider as the equivalent of cash mortgages assumed by the purchaser. In the present case, however, it does not appear that the purchaser assumes the mortgage on the property referred to above. He merely agreed to pay an amount to the seller equal to the amount of the mortgage on or before June —, 1927, as the final payment on

[13] See O. D. 848, page 476, holding that real estate dealers may not use inventories.

[14] See page 526.

the property. That the seller was not released by this agreement from liability on the mortgage is indicated in the statement in the letter from the taxpayer's representative that "the holder of the original mortgage against the property refused to release the taxpayer until payment of his obligation has been made in full." The amount of the mortgage, 42*x* dollars, should not, therefore, be considered as the equivalent of cash in determining the amount of the initial payment in this transaction. . . . . (C. B. 5, page 90; A. R. M. 140.)

Even if the mortgage had been assumed in the foregoing case, the sale would still be one of an instalment nature, since the down payment was small.

Where lien notes are given to cover future payments for property purchases, such notes are considered as cash to the extent of their discountable value.[15] When land is sold for part cash and part oil, if oil is found, the right to receive oil has not a "definitely ascertainable value" and no income is realized until the total payments received by the vendor exceed the cost of March 1, 1913, value of his land.[16]

When obligations of purchasers are the equivalent of cash.—

Regulation. In class (2) in article 44 the obligations assumed by the buyer are much better secured because of the margin afforded by the substantial first payment, and experience shows that the greater number of such sales are eventually carried out according to their terms. If these obligations have a readily realizable market value, as defined by article 1564, they are to be considered as the equivalent of cash and the profit realized from the transaction is taxable income for the year in which the initial payment was made and the obligation assumed. If the buyer defaults and the seller regains title to land by agreement or process of law, retaining payments previously made, he may deduct from his gross income as a loss in the year of repossession any excess of the amount previously reported as income over the amount actually received, and must include such real estate in his inventory[17] at its original cost to himself (less any depreciation as defined in arts. 161 and 162.) If the obligations have no readily realizable market value, the amount of the initial payment shall be applied against and reduce the basis, ... of the property sold and

[15] C. B. 4, page 89; O. D. 842.
[16] C. B. 4, page 89; O. D. 889.
[17] See Chapter XIX as to inventories.

if in excess of such basis, shall be taxable to the extent of the excess. . . . . Gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the basis as provided above and the amount realized therefor. . . . . (Art. 46.)

Even though the first payment is substantial in amount, if it is made in some form (note, property, etc.) that has not a readily realizable market value, the transaction is not closed and no income is realized.[18]

The two foregoing articles (45 and 46) must be reasonably construed. If transactions in class (2) are substantially the same as those in class (1), the Treasury could not hold that one is the equivalent of cash and the other not.

It has been held that the sum of payments made in the year in which the sale was consummated must be considered as the first payment.[19] This ruling is questionable. The true test is the plan—not the fortuitous collection of one or more instalments in one year.

It has been held that notes not readily discountable are not to be regarded as the equivalent of cash in determining whether the first payment is substantial.[20]

Sale of real estate in lots.—

Regulation. Where a tract of land is purchased with a view to dividing it into lots or parcels of ground to be sold as such the cost shall be equitably apportioned to the several lots or parcels and made a matter of record on the books of the taxpayer, to the end that any gain derived from the sale of any such lots or parcels which constitutes taxable income may be returned as income for the year in which the sale was made. This rule contemplates that there will be a measure of gain or loss on every lot or parcel sold, and not that the capital invested in the entire tract shall be extinguished before any taxable income shall be returned. The sale of each lot or parcel will be treated as a separate transaction and the gain or loss will be accounted for as provided in article 1561.[21] (Art. 43.)

The latest regulation refers to any gain "which constitutes

[18] For full discussion, see Chapter XXI.
[19] C. B. 3, page 108; O. D. 569.
[20] C. B. 1, page 76; O. D. 181.
[21] See Chapter XXII.

taxable income." For discussion of those transactions in which no gain is deemed to be realized, see Chapter XXI.

Ruling. . . . . For income tax purposes the sale of a perpetual easement on a specified number of acres of land to a railroad company is to be treated as though it were an outright sale of land where legal title passes at the time of sale, unless for some reason the fee of the owner has more than a merely nominal value, as for example, where the land is underlaid by a mine. (C. B. 5, page 89; O. D. 1072.)

Estimated development work may be included in cost.—

Ruling. Profit realized on the sale of lots, the selling price of which includes the cost of certain development work already made or to be made in accordance with the contract of sale, should be based on the cost of the land to the vendor, or its fair market value as of March 1, 1913, if acquired prior to that date, plus the actual and estimated future expenditures for development. If the estimated future expenditures should be subsequently ascertained to be incorrect, amended returns should be filed as the basis for an adjustment of the tax for the years affected. The cost of such development having been taken into consideration in determining profit, expenditures for this purpose can not be deducted from gross income in subsequent returns. (C. B. 3, page 108; O. D. 567.)

Repossession of real estate sold on instalment plan.—Article 42 states that in case of repossession "the property repossessed must be included in the inventory at its original cost."

Under another ruling real estate dealers are not permitted to inventory real estate.[22] Article 46,[23] which refers to real estate sales not on the instalment plan, uses similar language, as does article 42, which deals with sales of personal property on the instalment plan. Since the Treasury has held that real estate dealers may not use the inventory method, this gives them the benefits of the capital gains provisions.[24] The regulation merely provides that the cost of real estate sold and returned must not be written down. The net

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[22] O. D. 848, see page 476.
[23] See page 526.
[24] Section 206.

proceeds arising from the sale and return are of course taxable.

Ruling. In 1919, A sold a parcel of land which had a value on March 1, 1913, of x dollars for $5x$ dollars, receiving a cash payment of x dollars, the balance of the purchase price being secured by a purchase money mortgage payable on or before the end of five years in annual installments of $\frac{1}{5}x$ dollars or more.

A died before filing his 1919 income-tax return.

He left a will constituting B, his sister, the executor, and bequesting to her the residue of all his property.

Held, that the sale was made on the installment plan and that there should be reported as gain in A's income-tax return for 1919 that portion of x dollars (cash payment) received by him during the year which the gross profit to be realized when the property is paid for bears to the gross contract price, based upon the March 1, 1913, value unless cost to A was greater than the value on that date, in which event cost should be used.

The gain to be reported upon each installment paid will be the excess of the amount of the installment payments over the value of the claim to that installment at the date of the decedent's death.

During the administration of the estate gains from the transacions should be accounted for by the executor and after administration is completed by the residuary legatee under the will. In case the decedent had left no will the transaction would have been treated in accordance with the above ruling except after the administration was completed the heirs of the decedent would be required to account for the gains. (C. B. I-1, page 78; Digest I. T. 1192.)

The foregoing ruling would work out as follows:

The value on March 1, 1913 was $75,000, and the sale price in 1919, $100,000. The gross profit is 25 per cent. The down payment is $20,000. There would be reported in A's 1919 return ¼ thereof, or $5,000. The balance of the purchase price ($80,000) is represented by four notes of $20,000 each. A having bequeathed the notes to B, the latter collects each note and reports only the difference between $20,000 and the discounted value thereof at A's death.[25] The Treasury loses the tax on the balance of profit on the sale, or $20,000 ($25,000 profit on the entire transaction less $5,000 reported in A's 1919 return), less the tax on the discount on the notes applicable to the period between date of testator's death and the maturity of the notes.

[25] Section 202 (a-3).

CHAPTER XXI

INCOME FROM GAINS UPON SALE OR EXCHANGE OF PROPERTY—THE CLOSED TRANSACTION

The general provision in the law governing the taxation of gains from increases in property values reads as follows:

LAW. Section 213. . . . . **the term "gross income" (a) includes gains, profits and income derived from . . . . sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property . . . .**

The Supreme Court of the United States has decided that appreciation of property, accrued since March 1, 1913, and *realized*, is taxable under an income tax law.[1] The 1921 law provides, however, that capital net gains[2] realized after December 31, 1921, may be taxed at a rate not exceeding 12½ per cent.

Just prior to the passage of the 1921 law, the Treasury ruled that appreciation accrued *prior* to March 1, 1913, but realized in a subsequent year, is income (although not taxable) of the year in which realized, and is not the realization of taxpayers' capital at March 1, 1913.[3] This interpretation did not result in the taxation of the realization by a corporation, but it did result in the taxation of dividends paid out of such gains. The 1921 law, however, contains a provision which specifically states that "any . . . . increase in value of property accrued prior to March 1, 1913, may be distributed

[1] *Walsh v. Brewster,* 255 U. S. 536, 65 L. Ed 762, 41 Sup. Ct. 392; *Eldorado Coal & Mining Co. v. Mager* 255 U. S. 522, 41 Sup. Ct. 390, 65 L. Ed. 757; *Goodrich v. Edwards,* 255 U. S. 527, 41 Sup. Ct. 390, 65 L. Ed. 758; *Merchants' Loan & Trust Co. v. Smietanka,* 255 U. S. 509, 41 Sup. Ct. 386, 65 L. Ed. 751.

[2] **[Former Procedure]** Under all laws prior to that of 1921, capital gains were taxed at the same rates as other net income. For full discussion of capital net gains see page 624.

[3] The interpretations also affect invested capital. The rulings are superseded by the new regulations, see Chapter XXVII.

exempt from tax . . . ." to the recipients of such dividends.[4]

A somewhat similar problem arises in respect of dividends from a depletion reserve based on discovery value, i.e., whether or not it represents a distribution of profits or of capital.[5] The law contains no specific provision covering the point.

The changes in the 1921 law are not as radical as they appear to be. They are radical only when compared with the regulations under which prior laws were administered. The author believes that the inhibitions in the 1921 law against taxing apparent gains arising from exchanges, reorganizations, etc., should be looked upon as interpretations of the meaning of the term "closed transactions." If this is a correct inference, many of the rulings prior to 1922 defining the term must be revised. Taxpayers who actually continued their interests in capital assets but who have been taxed under the theory that they sold and repurchased the assets, have legal claims for refund of taxes assessed and paid.

The foregoing has been the consistent position of the author and is sustained in a recent decision,[6] wherein the court held that the Treasury's contention that a sale had taken place was not sound, but that the "substance and legal effect" of the transaction "was to leave all stockholding interests and all the corporate assets in precisely the same situation after the transaction was fully carried out as it was when it was begun."

No phase of federal income tax law and procedure is more perplexing and difficult than the determination of the

[4] Section 201 (b). In the 1921 and prior editions of this book the author exhaustively commented on the propriety of taxing capital gains. Numerous American and British authorities were cited. The author consistently supported the position that capital gains accruing after March 1, 1913, were taxable. In view of the decision in *Walsh v. Brewster* (supra) and other cases the matter is now of only academic interest. Those who are interested in the development of the subject should consult *Income Tax Procedure*, 1921, pages 394-402. For arguments as to excluding both capital gains and capital losses, see "Taxation of Capital Gains," by George O. May, *Journal of Accountancy*, November, 1922.

[5] See Chapter XXVII.

[6] *Stearn v. Weiss*, U. S. District Court, Nor. Dis. of Ohio, Feb. 17, 1922; see page 586.

tax liability in cases of such gains. Fundamental difficulties arise both as to when the gains shall be brought in to account for income tax purposes and in measuring the amount of such gains. This chapter deals with the first set of difficulties. It discusses the vexed question of the "closed transaction." Chapter XXII takes up the second set of difficulties, those relating to the measurement of the gain.

The Revenue Act of 1921 introduced new complications into the procedure by establishing a special rate to be applied to certain types of capital gains, by prescribing special methods of measuring certain capital gains, such as that from property received as a gift, and by materially changing the rules governing the "closed transaction."

The following section of the law relates particularly to the conditions which determine when the gains from sales or exchanges of property are to be brought into account.

LAW. Section 202. . . . . (c) For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—

(1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use;

(2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. . . . . [7]

(3) When (A) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For the purposes of this paragraph, a person is, or two or more persons are, "in control" of a corporation when owning at least 80 per centum of

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[7] For remainder of clause, see page 551.

the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation. . . .

The Closed Transaction—General Tests

When an outright sale is made for cash no problem exists; but transactions vary by imperceptible degrees from the outright sale for cash through various sorts of trades and exchanges to the transaction in which the property is too indefinitely valued to afford a basis for claiming that a "realization" has been made. Here serious problems of procedure arise. When is a sale a true sale in the sense of being a closed transaction rather than merely a continuing one?

As will be observed from the section quoted above, the law provides one definite and comprehensive test. In order to constitute a closed and taxable transaction the property received in exchange must:

1. Have a readily realizable market value.
2. Be of a different kind or use.

There are three main classes of exchanges which, even if they meet the test of "readily realizable market value," are still regarded as transactions not closed and taxable, viz.:

(a) Exchanges for property of like kind or use.
(b) Exchanges in reorganization.
(c) Exchanges of a limited type—so-called 80 per cent cases.

If the exchange is one which cannot be brought within the three classes of exempted cases enumerated above, the determination of the first test, i.e., has the property received in exchange "a readily realizable market value," is absolutely essential. If, on the other hand, the exchange can be made to fall in one of the three exempted cases, it is immaterial whether or not the property received in exchange has a readily realizable market value. The law specifically provides that such transactions are continuing and not taxable.

Regulation. Gain or loss arising from the acquisition and subsequent disposition of property is realized only when as the result of a transaction between the owner and another person the property is converted into other property (*a*) that is essentially different from the property disposed of, and (*b*) that has a readily realizable market value. . . . . (Art. 1564.)

Readily realizable market value.—The section of the 1921 law prescribing the qualities which the property received in exchange must possess to close the transaction, may be regarded as interpretative of former laws rather than as expressing new principles of taxation. In the 1918 law[8] appeared the words: "The equivalent of cash to the amount of its fair market value, if any." The average man sees no distinction between these words and this language of the new law: "No gain or loss shall be recognized unless the property received in exchange has a readily realizable market value."[9]

The first test stated in the law is a simple one, and the words, "readily realizable market value," should be strictly construed in favor of the taxpayer.[10] Some of the court de-

Some transactions were on the border line, such as cases where would-be purchasers did not acquire legal title but did acquire possession and beneficial interest. When the transactions were carefully marked out under the 1918 law, the mere fact that a saving in tax resulted could not transform a lease into a purchase. In dealing with the value of leases at March 1, 1913, the Treasury has held that the failure of lessees to acquire legal title is a fatal obstacle to their right to appreciation, even though the cases are highly meritorious. See further discussion in Chapter XXXVIII.

The Treasury disregarded form, legal title, etc. and imposed a tax, the validity of which is questionable, in a case where a taxpayer in 1919 executed a so-called lease of its property (with option to purchase for a nominal sum) for ten years. The lessee was an agent of the alleged purchaser who "advanced" the taxpayer the entire ten years' rental, taking the assigned lease as collateral. Held, that it was a closed transaction in 1919. (I-47-600; A. R. M. 189.)

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[8] See section 202 (b), page 564.

[9] Section 202 (c).

[10] **[Former Procedure]** Under the 1918 and prior laws the Treasury held that many transactions were closed (and therefore taxable) which were not so under any reasonable interpretation of the laws. For prior laws, regulations and rulings, and comments thereon, see *Income Tax Procedure*, 1921, pages 434-485.

cisions go so far as to say that gains or income must be realized in cash before they can be taxed, but it is not necessary to go so far. Taxpayers will be content if the actual income and not the unrealized income is taxed.

The author contends that this "readily realizable market value" should be founded on something more definite than a guess or even a value imputed from an occasional market quotation for similar property. The tax should rest upon a substantial foundation.

In discussing the regulations it is most important to keep in mind the basic principles involved. Unless readily realizable market value can be ascribed to what is received, the property received need not be evaluated at the time of exchange. An account receivable, contract, agreement, option or similar undertaking upon which a suit at law can be maintained, if it has a market value, as options frequently have, might be taxable. Yet if it could not be transferred or hypothecated, it could scarcely be said to have a readily realizable market value.

MEANING OF "READILY REALIZABLE MARKET VALUE."—

REGULATION. . . . . Property has a readily realizable market value if it can be readily converted into an amount of cash or its equivalent substantially equal to the fair value of the property. In other words, the property received in exchange must be readily marketable at substantially its fair value in order that a gain or loss be recognized. Property which is regularly traded in in a public market has a readily realizable market value in the quantities regularly traded in. Property may be salable, as in the case of a forced sale or in exceptional quantities, without having a readily realizable market value. Stock in a close corporation may or may not have a readily realizable market value, depending upon all the facts in each particular case. The question whether property has a readily realizable market value, and if so the amount thereof, is one of fact to be determined in each case in the light of all the surrounding circumstances; and attention should be called in the return to each exchange effected during the taxable year about which there could be any doubt. (Art. 1564.)

A full discussion of the meaning of the term "fair market

value or value March 1, 1913,"[11] appears elsewhere and need not be repeated here.

In the regulation just quoted, the term "fair value" is used as a measure by which to determine whether a conversion is into property having a "readily realizable value." The terms "fair value," "market value" and "fair market value" have been used interchangeably[12] by the Treasury in many cases.

The use of the term "readily realizable market value" presupposes an *actual* market. Property may be of great value, but there may be no "market" for it. Central Park in New York and the Treasury Building in Washington certainly are valuable, but there is no market for them. There is no willing buyer and no willing seller.

The framers of the law did not intend that a tax shall be imposed in respect of the "value" of the property received, but only in respect of its fair market value when determined in the usual way which must, however, also be readily realizable. Only in case there are both willing buyers *and* willing sellers is there a fair market value.

The following interpretation by the Treasury of the term "fair market value" under the 1918 law, issued at a time when the Treasury was construing the law with great strictness, throws some light on the probable official interpretation of "readily realizable market value."

Ruling. . . . . In the absence of reason to the contrary the words, "fair market value" must be given their ordinary meaning. The expression "market value," either with or without the adjective "fair," is a familiar one and has frequently been defined and explained. Without attempting in this recommendation to collate these definitions, it may be said that they amount in substance to this, that the "market value" of property is the fair value of the property in money as between one who wishes to purchase and one who wishes to sell. It is not, however, what can be obtained for the property when the owner is under peculiar compulsion to sell or the purchaser to buy; nor is it a purely speculative value which an owner could not reasonably expect

[11] See page 592 *et seq.*

[12] For a discussion of Treasury interpretation under the 1918 law, see *Income Tax Procedure*, 1921, page 461.

to obtain for the property although he might possibly be fortunate enough to do so. "Market value" is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts, will trade. It implies the existence of a public of possible buyers at a fair price. The adjective "fair" emphasizes the idea of fairness inherent in this conception of market value, and excludes any possibility of a construction of the words "market value" with reference to a market in which, or to circumstances of sale under which, for any reason a fair price could not be obtained. Under this interpretation property received in exchange for other property has no "fair market value" for the purpose of determining gain or loss resulting from such exchange when, owing to the condition of the market, there can be no reasonable expectation that the owner of the property, though wishing to sell, and any person wishing to buy will agree upon a price at which to trade unless one or the other is under some peculiar compulsion; that is, property has no "fair market value" when market conditions are such that there would be no trading in the property in question at a fair price. It does not follow, however, that property has no "fair market value" merely because there is no price therefor established by public sales or sales in the way of ordinary business. The fact that there is no "market price" or "current price" so established does not indicate that the property may not readily be sold at a fair price, and the meaning of "market value" is not ordinarily so restricted. The courts have recognized, not only that there are cases in which property has no "market value," or more properly "market price," in this restricted sense, but also that there are cases in which property has no "market value" in the broader sense in which the words are used in the statute as herein construed. See Wall *v.* Platt (169 Mass., 398); Montgomery County *v.* Schuylkill Bridge Co. (110 Pa. St., 54).

A construction of the statute in which the words "fair market value" are defined as above indicated is in accord with its theory and purpose. A fundamental consideration in income taxation is to determine when income, or elements essential to the computation of income, such as gain and loss, are realized. Clearly, gain or loss is realized upon the sale of property for cash. It seems, moreover, that even apart from express statutory provision gain or loss is realized from the exchange of property for other property which may fairly be said to be the equivalent of cash. See California Copper Syndicate *v.* Harris (41 Scot. L. R., 691; 5 Tax Cas. 159). Such was the ruling of the Bureau under the Revenue Acts of 1913 and 1916 (see Law Opinion 434), and the Revenue Act of 1918 expressly recognizes this principle in the language now under consideration in providing that "the property received in exchange shall . . . . be treated as the equivalent of cash." It is reasonable to regard property which has a "fair market value," as the words are herein defined,

as "the equivalent of cash." A taxpayer receiving such property can determine the amount of his gain or loss in terms of cash with a reasonable degree of certainty and can, if necessary, without undue sacrifice obtain by the sale of such property cash with which to pay his taxes. It is, however, unreasonable to regard property which has no "fair market value," in this sense, as "the equivalent of cash." A taxpayer receiving such property can neither determine the amount of his gain or loss with certainty nor obtain cash by sale of the property without sacrifice.

. . . . In determining whether property has a "fair market value" all available evidences must be considered. A case in which property has no "fair market value" should be regarded as unusual, and a determination that property has no "fair market value" should not be made lightly. Property is not without "fair market value" merely because there is a considerable divergence of opinion as to its value. "Fair market value" is to a large extent a matter of opinion and men of equally wise judgment will differ widely in their opinions. Frequently excellent evidence as to the "fair market value" of property, especially that which, though not ordinarily traded in, has a value in use, is found in its cost, or in the cost of reproducing it, with adjustments for depreciation and the like. (It should be noted, however, that while cost is frequently excellent evidence of "fair market value," "fair market value" may be either greater or less than cost and must, wherever made the statutory test, be taken regardless of its relation to cost.) As already pointed out, property can not be said to have no "fair market value" merely because no price therefor is established by public sales or sales in the way of ordinary business. Of course it is not essential that property be listed or traded in on any exchange in order that it may have a "fair market value." For example, stock in a small closely held corporation does not *ipso facto* lack "fair market value," nor does article 1563 of Regulations 45 so hold. Evidence as to the assets and liabilities of such a corporation and as to its earnings may furnish very definite indications as to its "fair market value." Even if a corporation is newly organized and has never done business as such, but has succeeded to the business of an individual or partnership, its stock will ordinarily have a "fair market value" ascertainable by reference to its assets and liabilities, the history of the specific business, and the history and conditions of the industry in general. Similar considerations apply to other kinds of property. . . . . (C. B. 1, page 40; T. B. R. 57.)

What constitutes a closed transaction?—

Official illustration of a closed transaction.—If in any one of the three main classes of cases (and their many

variations), which the law ordinarily regards as continuing transactions, the requirements of the statute are not fully met, the transaction then automatically becomes a closed one, resulting in gain or loss. An example, dealing with the special type of transfers under section 202 (c-3), is found in the following:

Regulation. . . . . (4) A owns certain property which he transfers to corporation X, a going concern, in which A owns no stock, in exchange for common stock of the corporation of the par value of $170,000. The X corporation has outstanding immediately after the transfer common stock of the par value of $200,000 and nonvoting preferred stock of the par value of $50,000. A realized a gain or loss from this exchange measured by the difference between the basis of the property exchanged and the fair market value, if readily realizable, of the stock received in the exchange. If the property exchanged was acquired prior to March 1, 1913, see article 1561.[13] (Art. 1566.)

Example 1—Where Gain or Loss Is Imputed

	Common	Preferred Non-voting
Stock owned before transfer	....	......
Stock received for property	$170,000	......
Total stock owned after transfer...........	$170,000 (a)	...... (c)
Total stock outstanding after transfer......	$200,000 (b)	$50,000 (d)
Percentage (a) is of (b)	85%	
Percentage (c) is of (d).................		.... .

In this illustration, if only $100 of preferred stock were outstanding, and the taxpayer owned that one share, no gain or loss would be imputed to the transfer of his property to the corporation, because he would then own at least 80 per cent of all classes of stock outstanding. The requirement of the statute that in addition to owning 80 per cent of the voting stock the taxpayer must also own "at least 80 per centum of the total number of shares of all other classes of stock of the corporation," in this case seems rather absurd.

[13] See page 564.

The language of the law is, however, explicit on this point and must obviously be complied with if the benefit of the section is to be had.

If A, on the other hand, had first formed a corporation of his own, paying in his property for the entire capital stock, and then exchanged such stock for stock in the M corporation, the transaction would be deemed a continuing one under section 202 (c-2) and therefore not taxable. The foregoing is sufficient to indicate how important is the form of organization and manner of exchange.

For examples where no gain or loss is imputed, see page 560.

Meaning of "like kind or use."—Section 202 (c-1), quoted on page 532, is a broad statement that there must be a change in both form and substance of the taxpayer's investment before any gain or loss is deemed to have arisen. The language of the law is clear and there can be no doubt as to its meaning. The Treasury regulation construing the words "like kind or use" reads as follows:

Regulation. Where property is exchanged for other property, even if the property received in exchange has a readily realizable market value, no gain or loss is recognized;

(*a*) Where property held for investment is exchanged for other property of a like kind, or where property held for productive use in trade or business is exchanged for other property of a like use, the words "like kind" are defined as having reference to the nature or character of the property and not its grade or quality. Therefore under this paragraph no gain or loss is realized by one other than a dealer from the exchange of real estate for real estate, or from the exchange of evidences of indebtedness (such as bonds and notes) for evidences of indebtedness, or from the exchange of shares of stock for other shares of stock, but one kind or class of property may not, under this paragraph, be exchanged for property of a different kind or class, as shares of stock for bonds, or real estate for personal property. Where evidences of indebtedness are exchanged for other evidences of indebtedness, the fact that any of the evidences of indebtedness involved in such exchange are secured by mortgage or other lien, or the fact that any real estate involved in an exchange is improved or unimproved makes no difference, for such facts re-

late only to grade or quality of the property and not to its kind or class. There is excluded from the provisions of this paragraph stock-in-trade or other property held primarily for sale. Unproductive real estate held by one other than a dealer, for future use or future realization of the increment in value, is held for investment and not primarily for sale. . . . . (Art. 1566.)

It will be observed from the foregoing article that a liberal interpretation is given of the term "property of like kind" which may be exchanged without either party to the transaction realizing any taxable income. United States Steel stock, for instance, may be exchanged for shares of Pennsylvania Railroad without any taxable income resulting therefrom, even if the Steel stock had been purchased years before at a very low figure. Unsecured notes may be exchanged for mortgage bonds without any taxable profit (or deductible loss) arising from the exchange. Again, unimproved real estate may be exchanged for improved real estate, and vice versa.

It will be observed, however, that the Treasury distinguishes sharply between classes of securities, stocks and evidences of indebtedness (bonds, notes, etc.) not being deemed to be property of "like kind."[14] Therefore, an exchange of United States Steel stock for Pennsylvania Railroad bonds would, under the Treasury's regulation, be deemed a closed transaction. Reorganizations are covered by a different subdivision of section 202 from that dealing with exchanges of property in general. To the latter class of transactions the phrase "like kind or use"[15] is applicable.

The Treasury regulation already quoted deals chiefly with the words "like kind," and has little to say of the words "or use" which also appear in section 202 (c-1) of the law in the same connection. It does, however, make it clear that the Treasury conceives the phrase "like kind" to apply merely to

[14] Usually no confusion arises because bonds are, and stocks are not, liabilities. The test is the fact and not the name. The charter of the city of New York (section 169) provides that "all bonds issued . . . . excepting assessment bonds and revenue bonds shall be known as 'corporate stock of the City of New York.'" Therefore corporate stock of the City of New York is a bond.

[15] See page 540.

property held for investment and the word "use" to apply to property held for productive use in a trade or business.

Article 1566 intimates that real estate dealers are not permitted to exchange one piece of property for another and to consider that the transaction is continuing. This forces the Treasury into the position of asserting that real estate dealers should inventory their properties like other merchants, a practice which the Treasury still refuses to recognize. It will be necessary for the Treasury to choose "which horse it wishes to ride."

One of the controlling factors in all such transactions is the intention of the parties; in almost all cases the question: "Is it a continuing or closed transaction?" can be settled by easily ascertainable facts. Section 202 is eminently fair and a reasonable administration of its provisions will not result inequitably.

Meaning of "exchange."—The possibility of exchanging investments instead of selling them and thus postponing the necessity of accounting for gains has been fully appreciated by brokerage and bond houses. Numerous circulars have been issued by such concerns calling attention to the situation created by the passage of the 1921 law and offering to arrange exchanges. This has made it necessary for the Treasury to distinguish precisely between true sales and transactions which may be fairly classed as exchanges.

Ruling. It is provided in section 202 (c) 1 of the Revenue Act of 1921 that, for the purposes of income tax, no gain or loss shall be recognized when property held for investment or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale) is exchanged for property of a like kind or use.

Many taxpayers and salesmen of securities are interpreting this to mean that all sales of securities and the immediate purchase of like securities are exchanges resulting in no gain or loss. Such interpretation of the law and regulations is erroneous.

The Bureau realizes that in many cases it is difficult to determine whether the transaction is a true exchange or really a sale and reinvestment of the proceeds in other securities. To constitute an ex-

change within the meaning of section 202 (c) 1 and of article 1566 (a), the transaction must be a reciprocal transfer of property for property as distinguished from a transfer of property for a money consideration. In such an exchange neither principal would pay a commission to the other, although if a broker, in his capacity as such, negotiated the exchange for either principal, the fact that the broker was paid a commission for his services would not of itself take the transaction out of the classification as an exchange.

If a person owning 100 shares of stock in A corporation should instruct a broker to exchange them for shares of stock in B corporation, it would be essential, in order to bring the transaction within the meaning of the exchange provisions of the Revenue Act, that the person owning the shares of B corporation stock should receive the 100 shares of A corporation stock and that the person owning the 100 shares of A corporation stock should receive the shares of B corporation stock. The stock received in exchange should be treated by each party as taking the place of the property exchanged. If, on the other hand, the instructions to the broker are in effect to sell 100 shares of stock in A corporation and invest the proceeds in shares of stock in B corporation, the transaction can not be treated as an exchange, but is a sale of A corporation stock and a purchase of B corporation stock. The element of exchange in this case is lacking, as there is no reciprocal transfer of securities between principals unless by mere coincidence. Where the broker in the transaction, whatever his instructions may be, sells the stock in A corporation and then buys the stock in B corporation, or buys the stock in B corporation and then sells the stock in A corporation, there is an interval of time, however short, during which one or both of the customers would have title to no securities whatever. In a true exchange the passing of title to the stock in the A corporation and acquisition of title to the stock in the B corporation, and vice versa, would be simultaneous as to both parties to the exchange. In all cases where there is a doubt as to whether the transaction is a sale or an exchange, all facts connected with the transaction should be submitted to the Bureau of Internal Revenue for a ruling in the matter. (I-32-446; I. T. 1410.)

The Treasury distinguishes an "exchange" from a "sale and reinvestment." To effect the former, the broker must turn over a security from his "stock-in-trade." If he has not "in stock" the particular security his customer wishes, the broker must find someone who will exchange with his customer, and for his services the broker may charge a commission.

Under section 202 (e)[16] cash adjustments are permissible in such exchanges and serve to increase or decrease the profit or loss on subsequent sale, depending on whether cash is received or paid in the exchange referred to above.

For example, A owns bonds which cost (subsequent to March 1, 1913) $7,000, now worth $8,500, which he exchanges with B for bonds worth $8,000 and $500 cash. The $500 is applied to reduce the cost ($7,000) of the original bonds, whose place is taken by the new bonds, and which are considered, for tax purposes, as having cost $6,500 ($7,000 — $500).

Assuming that B had paid $7,500 for his old bonds (since March 1, 1913), then the bonds he received in exchange from A would be assigned a cost of $8,000 ($7,500 cost of old bonds, plus $500 cash paid A).

The Treasury has ruled that the mere fact that the agent arranging the transaction is an investment dealer rather than a broker, does not affect the case. The tests outlined in the ruling quoted on page 542 still apply.

Ruling. A, an investment dealer, acquired from B, the taxpayer, not a dealer, a bond of the M Company for $955 and B acquired from A on the same date a bond of the O Company at a cost of $900.

If the transaction with the taxpayer was a true exchange—that is, if the dealer traded a bond which was a part of his stock in trade, and was owned by him, for another bond owned by the taxpayer—the taxpayer may report the transaction as an exchange in accordance with the provisions of section 202 (c). If, however, the dealer acted in effect as his broker and purchased the bond of the O corporation for B, the taxpayer's transaction was simply a sale of the bond of the M Company, followed by a purchase of the O Company bond, and he may not treat such separate transactions as an exchange. The fact that A is an investment dealer, not a broker, does not in itself make the transaction an exchange if, in effect, A acted as B's agent or broker in this particular transaction. Nor are the book entries or confirmation slip conclusive evidence one way or the other, the actual facts being determinative. (I-27-384; I. T. 1377.)

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[16] See page 586 for full discussion of the basis for computing gain or loss on subsequent sales.

MEANING OF "HELD FOR INVESTMENT."—No official interpretation has been made of the phrase "held for investment," used in section 202 (c-1) of the law. Apparently the phrase is intended to exclude both property held for consumption and property held for trading. But the term "trading" should be limited to the stock-in-trade of dealers.

Dealers sometimes hold property for investment. When they do, they are entitled to the benefits of the section.

It would appear that in all cases where the Treasury does not permit the use of the inventory method, a case can be made for considering the property an investment.

The word "investment" is thus defined by the Standard Dictionary: "the act of investing or laying out money productively, or otherwise, or converting capital, especially in a permanent manner; also the money or capital so invested, or the property invested in."

In 23 Cyc. 349, the following definition is found:

> In common parlance, the term means the putting out of money on interest, either by way of loan or purchase of income-producing property; a form of property viewed as a vehicle in which money may be invested; the loaning or putting out of money at interest, so as to produce an income; some species of property from which an income or profit is expected to be derived in the ordinary course of trade or business, as distinguished from speculation.

The Treasury must interpret the word in its usual or common meaning, which means a broad—not a narrow—interpretation.

SECURITIES HELD "ON MARGIN."—The question has been asked, "Can securities carried in a margin account be deemed to be 'held for investment'?" There can be little doubt about the answer. Few securities carried in margin accounts are the stock-in-trade of their owners.[17] If not stock-in-trade, the securities must be held for investment, even though the margin accounts are speculative accounts. Property owned does not

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[17] For Treasury's definition of "stock-in-trade," see page 544.

lose its character because the owner hopes to dispose of it quickly or because he borrows money on it.

Transactions Which May or May Not Result in Taxable Gains

Transactions on the border line, which may or may not result in taxable gains are discussed in the pages which follow.

When sale is made on instalment plan can tax be deferred? —In many cases of sales of property the seller attempts to arrange that the proceeds of the sale shall be received in instalments over a period of years, thus deferring the imposition of the tax. It is not feasible to discuss at length in this book arrangements of this nature. If the purchaser is not in good financial standing, or the seller retains title to his property, or the cash payments are distributed over a long period of years, the transaction certainly cannot be considered as closed. If the purchaser delivers his obligations to pay in such form as to render them the equivalent of cash, the transaction is a closed one and a tax will be imposed on the realized profit.

The owner of several magazines, who is said to have a net income of a million dollars a year, purchased a newspaper and gave five promissory notes in payment. The notes were for $100,000 each and matured annually for five years. The seller, who kept his books on the accrual basis, entered the notes as the equivalent of cash. In submitting his balance sheet to a federal reserve bank he was informed that he should not have included the notes as current assets. In the circumstances the Treasury could hardly hold that the notes were the equivalent of cash. In view of the rulings applicable to instalment houses and to sales of property on an instalment basis,[18] taxpayers need not consider that notes and other securities are the equivalent of cash unless they can readily be discounted at a reasonable rate of interest.

[18] See Chapter XX.

If shares of stock are sold and delivery of part (and payment therefor) is postponed, the transaction should be deemed to be closed or not closed depending on the terms of the contract of sale.

Proceeds of sale of goodwill may be taxable.—When an individual or a partnership sells a business and its goodwill is an element, part of the purchase price is paid for goodwill, and the question arises as to the taxable status of the vendor. The question is not the same whether cash or securities are received, because in the former case there is a realization and the question settles down to the basis of the tax; in the latter case no actual realization, as a rule, takes place.

Regulation. Any profit or loss resulting from a sale of good will can be taken only when the business, or a part of it, to which the good will attaches is sold, in which case the profit or loss will be determined upon the basis of the cost of the assets, including good will. If the good will was acquired prior to March 1, 1913, the taxable gain or deductible loss should be ascertained in accordance with the provisions of article 1561. If specific payment was not made for good will acquired after February 28, 1913, there can be no deductible loss with respect thereto, but profit may be realized from the sale of good will built up through expenditures which have been currently deducted. It is immaterial that good will may never have been carried on the books as an asset, but the burden of proof is on the taxpayer to establish the cost or fair market value on March 1, 1913, of the good will sold. (Art. 41.)

Are profits on sale of rights to subscribe to stock taxable?—One form in which appreciation in the value of property sometimes asserts itself, is the privilege given to a stockholder to subscribe to a new issue of stock upon particularly favorable terms. These "rights" in some cases undoubtedly represent an increase in the value of the stockholder's interest in the company. Under the 1918 regulations the Treasury attempted to tax the entire proceeds of the sale of such rights as income relying[19] upon the case of *Tax Commissioner v.*

[19] T. B. M. 73; C. B. 1, page 71.

Putnam.[20] In 1921 a United States district court pointed out that this case was based on the theory that stock dividends were income and that under the federal law the gross proceeds from the sale of rights are not taxable.[21] The decision of the district court was affirmed by the Supreme Court on May 29, 1922.[22]

On October 18, 1922, the Treasury reversed its former position and amended the pertinent section of both Regulations 62 and 45 to read:

> REGULATION. . . . . Where a corporation issues to its stockholders the right to subscribe to its stock, the value of the right does not constitute taxable income to the stockholder, but gain may be derived or loss sustained by the stockholder from the sale of such right. . . . . (Art. 39, as amended by T. D. 3403, October 18, 1922.)

The measurement of the gain upon sale of rights is discussed in Chapter XXII.

Is an option to purchase property at a price below its market value taxable?—When a taxpayer receives a "right" to subscribe to stock or other securities and sells the right the Treasury holds that the transaction may result in taxable income.

When the right is not sold and the security is purchased no income is deemed to accrue, even though the actual market value of the new security is greatly in excess of the option price, unless and until the security is subsequently sold at a profit. The theory is that no gain, profit or income has been *realized,* and that the accrual to the original investor is merely appreciation in value. There are, however, other kinds of rights or options which are in a different class. If a valuable option is received for services rendered, it could hardly be deemed to be a continuing transaction.

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[20] 227 Mass. 522, 116 N. E. 904, L. R. A. 1917 F. 806.

[21] *Safe Deposit & Trust Co. of Baltimore v. Miles,* 273 Fed. 822. The position taken by the author had been that the proceeds from sale of rights was not all income. See *Income Tax Procedure,* 1921, page 449.

[22] Advance opinions, 66 L. Ed. 570, 42 Sup. Ct. 483.

If a stockholder sold his stock partly for cash and partly for an option to buy other property at a price considerably less than its fair market value, the option being assignable, it might or might not be a closed transaction, depending on whether or not it had a readily realizable market value.

It may be claimed that if an option is not exercised no profit can accrue, and so long as the option has not been exercised there has been no realization and it is not a closed transaction as defined by the regulations. The case is somewhat analogous to the receipt of the proceeds of a sale, of a Liberty bond or currency, which later is lost or stolen. The proceeds or gain of the sale would never be realized in the sense of any permanent advantage to the taxpayer. He had the cash, but he lost it; and he had the option, which he might have sold, but did not.

Therefore, if an option can freely be sold at the date of receipt, it is probable that it will be taxed. Most options, however, cannot be deemed to be the equivalent of cash, and the exercise thereof constitutes a continuing rather than a closed transaction.

Sale with reservation of ground rent.—A sale was made and a form of lease executed with reservation of ground rent, payable annually, equal to interest upon balance of purchase price. Even though the ground rent was redeemable at the option of the tenant, the transaction was held not to be closed, but that when the ground rent is redeemed, gain or loss may result.[23]

Sales of real estate, if the first payment is more than 25 per cent, are treated as the equivalent of cash. If less than 25 per cent, the sale is considered as on the instalment basis.[24] In such cases, however, the seller has the definite obligations of the purchaser (even though such obligations may not have a readily realizable market value at the time of receipt). He

[23] C. B. 5, page 98; O. D. 1089.
[24] See Chapter XX.

can realize on these obligations as they mature. In the case of the ground rent he realizes nothing unless and until the tenant exercises the option to redeem. The ground rent itself is equivalent to interest on the unpaid principal and is taxable.

Sale of capital assets by a corporation.—When a corporation sells its assets for an amount in excess of their book value (subject to adjustment for actual value at March 1, 1913), the corporation will be taxed on the excess. In turn the stockholders, when distribution is made, will be taxed on the same amount, less the tax paid by the corporation. In order to avoid this double taxation the individual stockholders of the selling corporation should sell their stock to the vendee. When the purchaser acquires all the stock he or it may cause all of the assets of the corporation to be turned over for a nominal consideration. Thus the books of the corporation will not show any profit on the sale.[25]

Ruling. If, upon the sale of the capital assets of a corporation to another corporation, shares of stock are surrendered by the old stockholders to the vendee corporation, the nature of the transaction is not changed from one of the sale by the corporation to one of sale of stock by the stockholders. (C. B. 2, page 211; A. R. M. 21.)

The ruling is highly technical and was issued under the 1918 law. If the vendee corporation purchased the old shares directly from the *stockholders* or arranged an exchange with such stockholders, it could not be held that the vendor *corporation* made the sale. If the vendor corporation as a corporation foolishly arranged and made the sale and the stockholders merely *surrendered* their stock the old corporation would be subject to tax.

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[25] **[Former Procedure]** The Treasury has sent to taxpayers in such cases an elaborate questionnaire to determine whether the old corporation sold its assets to the new corporation or whether the old stockholders sold or exchanged their stock. If the former, the Treasury usually assesses the old corporation in the face of an old Treasury regulation to the contrary. See also *Income Tax Procedure,* 1922, page 555.

Reorganizations, Mergers and Consolidations

The 1921 law in effect provides that taxable income does not arise from reorganizations,[26] even if the property received in exchange has a readily realizable market value, unless the security holders dispose of the securities received by them in the reorganization.

LAW. Section 202. . . . . (c) . . . . (2) . . . . **The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected); . . . .** [27]

REGULATION. . . . . Under this paragraph it makes no difference whether the stock or securities received are or are not of a like kind or class. So long as the property received in the reorganization consists of stock or securities within the usual meaning and acceptation of these terms, no gain or loss is recognized. Where two or more corporations unite their properties, by either (1) the dissolution of corporation B and the sale of its assets to corporation A, or (2) the sale of its property by B to A, or (3) the sale of the stock of B to A, or (4) the merger of B into A, or (5) the consolidation of A and B, or (6) the acquisition by A of a majority of the voting stock and a majority of the total number of shares of all other classes of stock of B or of substantially all of the properties of B, no taxable income is received from the transaction by A or B or by the stockholders of either corporation A or corporation B, provided the sole consideration received by the stockholders is stock or securities of corporations A or B or any corporation a party to or resulting from the reorganization. Where in connection with an internal adjustment of the affairs of a corporation, either by recapitalization or a change in identity, form, or domicile (however effected), a person receives in place of the stock or securities owned by him new stock or securities of the corporation, no gain or loss is realized. . . . . (Art. 1566.)

The section of the law quoted above means that exchanges are continuing transactions in the following cases:

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[26] [Former Procedure] The taxation of gains or alleged gains arising from reorganizations prior to January 1, 1922, is a highly complicated and technical subject. For full discussion see *Income Tax Procedure*, 1921, Chapters XIV and XV, and *Income Tax Procedure*, 1922, pages 564-566.

[27] For remainder of section see page 532.

1. Merger.
2. Consolidation.
3. Acquisition by one corporation of majority of the voting stock plus majority of all other classes of stock } of another corporation
4. Acquisition by one corporation of substantially all the properties of another corporation.
5. Recapitalization.
6. Change in identity.
7. Change in form.
8. Change in place of organization.

Simply stated, if a taxpayer in a "reorganization" receives in exchange nothing but new securities, the transaction is not a closed one.

The foregoing may be summarized into two main groups, viz.:

1. Changes in substance and form which include classes 1 to 5; and
2. Changes only in form, which include classes 6 to 8.

The Treasury has ruled that no occasion for accounting for possible taxable gain arises when a corporation obtains a new charter in place of one which has expired, in a case where a new charter must be taken out in order that the principal place of business may be changed.[28]

Under previous laws the Treasury has held that very slight changes in corporate entities result in closed transactions and subject the owners of the so-called new securities to tax. The 1921 law definitely settles the question for the future and may be used as interpretative of the past.

Section 202 (c-2) of the 1921 law groups changes in identity, form and place of organization with reorganizations generally, which are not taxable even though the new securities have a readily realizable market value. The requirement

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[28] C. B. I-1, page 32; I. T. 1152.

that a substantial interest be retained in the new securities, hardly applies to mere changes in form, since the new ownership is usually precisely the same as the old.

The terms used in section 202 (c-2) include financial transactions in which usually there are changes in substance as well as in form. There is a loss and mingling of identity which may or may not assume a taxable status. As heretofore stated, no tax will be imposed if there is no readily realizable market value for the new securities or other property. No tax will be imposed if one corporation when it acquires an interest in another corporation secures at least a majority interest. It will be recalled further that under section 202 (c-3) of the law[29] no tax will be imposed when (a) transfers of property are made by an individual or a corporation to a corporation, or (b) when two or more individuals jointly or two or more corporations jointly convey property to a corporation, provided in the case of (a) the previous owner is in control and owns at least 80 per cent of all of the voting shares plus 80 per cent of all other shares of the new corporation. In case of (b) it is sufficient if the same affiliated group (individuals or corporations) who conveyed the property, jointly own and control the 80 per cent interest.[30]

Cash adjustments may be made.—The limitation in article 1566 that in reorganizations no taxable income is received "provided the sole consideration received by the stockholders is stock or securities" of the reorganized or merged company or companies, is not warranted by the law. Section 202 (e) provides in such cases that the cash received "shall be applied against and reduce the basis . . . . of the property exchanged. . . . ." In other words, specific provision is made that when securities and cash are received in a re-

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[29] See page 532.

[30] For discussion of the further limitation in section 202 (c-3) that the new securities received must be in "substantially the same proportion" as the interests of the old owners "in the property before such transfer," see page 555.

organization the cash serves to reduce the cost (or March 1, 1913, value) of the old securities, which now is deemed to be the cost of the new securities.

In many reorganizations cash adjustments are necessary. The limitation in article 1566 is confusing and the regulations should be amended to conform to section 202 (e). The same phraseology is found in article 1567 of Regulations 45 issued under the 1918 law, and the limitation referred to may have been inadvertently carried forward in Regulations 62.

Partnerships and individual businesses excluded from "reorganization."—Section 202 (c-2) refers to the reorganization of one or more "corporations." Therefore, before merging or consolidating a partnership or individual business with that of a corporation, it is advisable to incorporate [under section 202 (c-3)[31]] and then bring such new company into the merger with the other corporations by effecting an exchange of securities.

Changes in substance and form.—The 1921 law makes it clear that exchanges of securities or other property, even though the securities received have a readily realizable market value, and there is a change in substance, *may* not be taxable in some cases. These cases depend almost entirely on the percentage of ownership in the properties which is retained by the old owners. When there is a change in substance, and the old owners do not retain a substantial interest in the new property, and there is a readily realizable market value for the new securities, it is entirely reasonable to consider the transaction a closed one.

New property must have readily realizable value.—Section 202 (c) provides that no tax will be imposed in any case when the property received has no readily realizable market value.[32]

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[31] See page 532.
[32] See page 534.

WHAT CONSTITUTES "LIKE KIND OR USE."—Article 1566 defining the words "like kind" has already been quoted and commented upon on page 540 *et seq.* in connection with the subject of closed transactions. Further comment on this point seems unnecessary, except that it should be noted that the exchange must be a 100 per cent one in order to avoid the possibility of tax. If part cash is received there may or may not be any tax, depending on the basis prescribed in section 202 (e).[33]

Transfer of property to a corporation.—Clause (A) of section 202 (c-3)[34] covers the simple and familiar case of incorporation of an individual or partnership business as well as the case where an individual contributes additional capital to a corporation. It also covers those infrequent cases of transfers of property from a corporation to its subsidiary.

It is when we deal with clause (B) (when two or more make the transfer) that we are confronted with a more perplexing problem.

In the case of both (A) and (B) the law provides a definite limitation that 80 per cent control of the corporation must remain in the transferees. That subject is discussed hereinafter. In addition, in the case of (B) there is another limitation. That is, the transfer is a continuing transaction only if "the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer."

Assume that A and B each own an undivided one-half interest in a piece of real estate. They pay it in to a corporation, each taking 50 per cent of its stock. In such a simple case the requirements of the law as to "substantially the same proportion" is clearly met. But assume the following:

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[33] See page 587.
[34] See page 532.

	Per Cent Holdings in Old Company	Securities of New Company Per Cent Bonds	Per Cent Stock
Stock of Old Company (all one class):			
Stockholder A.................	7	8	None
" B.................	15	4	12
" C.................	8	1	9
" D.................	70	77	74
	100		
Partnership:			
1 partner (having 60% capital interest)		6	3
1 partner (having 40% capital interest)		4	2
	100%	100	100

In the foregoing illustration the old interests have 100 per cent control in the new corporation. But neither the stock, nor the bonds, nor both, of the new corporation are in substantially the same proportion as their interests in the property before such transfer—that is, unless a broad and liberal interpretation is had. For example, consider the partnership property, in which one partner had a 60 per cent interest before the transfer. After the transfer he has a 3 per cent stock interest in the net worth of the corporation and he owns 6 per cent of the bonds. It would appear that "substantially the same proportion" prevents any substantial rearrangement of securities at the time of transfer.

On the other hand, it would not be reasonable to contend that, inasmuch as the securities of the new corporation allotted to the partnership for its net assets were taken by the partners between them in the same ratio or proportion as their former interests in the partnership, the "substantially the same proportion" requirement of section 202 (c-3) has been met so far as the former partners are concerned. It is assumed that the old corporation and the partnership had agreed between them that the latter's net assets were worth 10 per cent in bonds and 5 per cent in stock of the new corporation.

So far as the stockholders of the old corporation are concerned, it is not certain that they have met the test referred to above. As will be seen from the foregoing tabulation,

the old stockholders do not have the same proportionate interest as a whole in the new corporation (in the aggregate their holdings are 90 per cent of the new bonds and 95 per cent of new stock), nor do they individually have the same proportionate interest in either bonds or stock of the new corporation. Stockholder A, for instance, gets only bonds and no stock at all in the new corporation. Stockholder C who had 8 per cent of the old stock gets 9 per cent out of a total 95 per cent of new stock distributed to the old stockholders, and only 1 per cent of the 90 per cent bonds distributed to them.

The problem would be still further complicated if the old corporation, instead of having only one class of stock as in the foregoing illustration, had several classes of stock (with stockholders holding varying percentages thereof) and perhaps also one or more classes of bonds. It may well be questioned whether Congress intended section 202 (c-3) to apply such a complicated test as indicated by the foregoing. It would seem more reasonable to interpret the phrase "substantially the same proportion" as referring to the proportionate interests of individuals, partnerships and corporate entities which transfer "property, real, personal or mixed to a corporation." If this interpretation be correct, the corporation and partnership, which in the foregoing illustration have consolidated by transferring their properties to a new corporation, came within the provisions of section 202 (c-3), even though the stockholders of the old company have divided among themselves the securities of the new company (received en bloc for the properties of the old company) in different ratios than their holdings of the old stock. It is not to be overlooked that the term "persons" used in section 202 (c-3) is defined by section 2 of the law to include partnerships and corporations, as well as individuals.

When a minority interest of as much as 20 per cent is introduced (as is permitted under the law), the difficulties of determining what constitutes "substantially the same propor-

tion" are increased. The prudent thing to do is so to arrange the reorganization that it can be brought under section 202 (c-2), if it should be found wanting under section 202 (c-3). This could be accomplished, in the foregoing illustration, by incorporating the partnership under section 202 (c-3), and then effecting a reorganization under section 202 (c-2). In fact a combination of these two subdivisions can be availed of for overcoming many of the obstacles heretofore placed in the path of corporate reorganizations from a tax standpoint. The Treasury during 1922 has issued practically no official rulings on the subject, but it is safe to assume that it will try to bring a particular case within that subdivision under which the taxpayer will have most difficulty in meeting the requirements of the statute.

It will be asked, "What happens if in case of a transfer described in section 202 (c-3) of the law the continuing interest is only 79 per cent?" The answer is not easy. If the new shares have no readily realizable market value, there is no tax. If the new shares have a readily marketable value, it means that ownership to the extent of 21 per cent has been disposed of and must be accounted for under section 202 (e), and it is deemed to be proper to consider the other 79 per cent the equivalent of cash. If there is a ready market, cash can be raised to pay the tax. Any gain would no doubt be a capital gain taxable at the special rate applied to capital gains, providing the securities exchanged had been held two years. The 80 per cent provision applies only to the time "immediately after the transfer." Subsequent sales are not taxable unless the proceeds exceed the cost or March 1, 1913, value of the old securities.

Under section 202 (c-1), when property is exchanged for other property of a like kind or use no tax is imposed. It would seem that when stock of one corporation is transferred to another corporation and 79 per cent (or any lesser percentage) ownership of the stock of the new corporation is retained, the conditions of section 202 (c-1) are fulfilled and

that no taxable income can accrue (unless the proceeds from the sale of the 21 per cent interest exceed the total cost or March 1, 1913, value), because the proceeds will be credited against cost or value as provided in section 202 (e). Furthermore, section 202 (c-3) seems to conflict with section 202 (c-2). The latter deals with reorganizations, etc. It would seem to be possible for those who desire to form a new corporation, [section 202 (c-3)], to arrange to own and control at least 80 per cent of its stock "immediately after" its organization. The next step would be to consolidate with another corporation under section 202 (c-2), in which case it is only necessary to retain a majority interest in the new corporation. Even though the securities of the new corporation are readily marketable, no tax can be imposed.

Official illustrations of continuing transactions.—

Regulation. . . . . (1) A and B each own an undivided one-half interest in certain property. Corporation X is created, to which A and B transfer the property, each receiving in exchange therefor 50 per cent of the stock of the corporation X. No gain or loss is realized from this exchange.

(2) A, who owns common stock in the X corporation of the par value of $70,000, transfers certain property to the corporation, for which he received additional common stock of the par value of $15,000. The X corporation has outstanding immediately after the transfer only common stock of the par value of $100,000. No gain or loss is realized from this exchange.

(3) A owns certain property which he transfers to the corporation X, a going concern, in which he owns common stock of the par value of $280,000 and class A nonvoting preferred stock of the par value of $190,000. A receives in exchange for the property common stock of the par value of $70,000. The X corporation immediately after the transfer has outstanding common stock of the par value of $400,000, class A nonvoting preferred stock of the par value of $200,000 and class B nonvoting preferred stock of the par value of $25,000. No gain or loss is realized from this exchange. . . . . (Art. 1566.)

In (1) there is no gain because the old interests own and control more than 80 per cent of the new corporation; also

it is to be noted that the respective stock holdings of A and B in the new corporation are in the same proportions or ratio as their respective interests in the property transferred to the corporation.[35]

In (2) the continuing interest is 85 per cent.

In (3) the continuing interest is 86.4 per cent.

In statement form, examples (2) and (3) given in the foregoing regulation appear as follows:

EXAMPLE 2—NO GAIN OR LOSS IS IMPUTED

	Common (par value)	Preferred, Class A Non-voting (par value)	Preferred, Class B Non-voting (par value)
Stock owned by individual before transferring property	$ 70,000		
Stock received by individual for property transferred	15,000		
Total stock owned by individual after transfer	$ 85,000 (a)		
Total stock outstanding after transfer	$100,000 (b)		
Percentage (a) is of (b).........	85%		

EXAMPLE 3—NO GAIN OR LOSS IS IMPUTED

	Common	Preferred, Class A	Preferred, Class B
Stock owned before transfer......	$280,000	$190,000	......
Stock received for property......	70,000	....	......
Total stock owned after transfer..	$350,000 (a)	$190,000 (c)	......
Total stock outstanding after transfer	$400,000 (b)	$200,000 (d)	$25,000 (e)
Percentage which (a) is of (b)..	87.5%		
Percentage which (c) is of (d) plus (e)...		84.4%	
Percentage which (a) plus (c) is of (b) plus (d) plus (e).....................			86.4%

In the foregoing illustration, if the taxpayer held $175,000 of class A preferred stock, instead of $190,000, he would be denied the benefit of the reorganization provision. He would control 87.5 per cent of the common stock, and 87.5 per cent of the class A preferred, but his preferred holding would be

[35] See page 555 *et seq.*

only 77.8 per cent of the total of both classes of preferred outstanding.

Purchase of assets by bondholders.—It frequently happens that bondholders, in order to protect themselves, purchase outright the property represented by their bonds, or exchange their bonds for stock in a reorganized company which purchases the assets of the old corporation. In such cases the assets may be transferred to a new corporation and no tax will be imposed if the assignors retain more than 80 per cent of the stock of the new corporation.

Disposition of surplus of dissolved corporation.—Practically all reorganizations and consolidations result in the dissolution of pre-existing corporations. Taxpayers who receive cash or securities from a dissolving corporation should inquire as to whether or not the old corporation had an undistributed surplus account on its books. If so, such surplus as and when distributed to stockholders in dividends (or the equivalent of dividends) was free from all tax as to the part accumulated prior to March 1, 1913, and free from the normal tax as to the part earned after March 1, 1913.[36]

Dissolution of limited partnerships.—The procedure in the case of dissolution of limited partnerships of the corporation type[37] is the same as that for corporations. When there is a large surplus at the date of distribution, it must be borne in mind that the normal income tax has been paid on all accumulations since March 1, 1913. If securities in a new corporation or limited partnership are received in exchange, it would be regarded as a distribution in kind and no tax would be imposed unless and until the securities were subsequently disposed of by the individual partners.[38]

If the old partnership distributes the new securities to its

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[36] See Chapter XXVII as to dividends.
[37] See Chapter II.
[38] See Chapter XXII.

shareholders, the transaction will be deemed a continuing one, under section 202 (c-3).[39]

Securities in reorganization issued to third party.—

RULING. . . . . On December —, 1917, A offered to sell to the corporation all his right, title, and interest in and to the assets of the business that had been conducted by him in consideration of the issuance of 48.98y shares of stock of the corporation to seven persons who were named in the offer. . . . .

Inasmuch as the contract was enforceable by the third parties upon the acceptance of the offer by the corporation and the transaction was bona fide, title to the stock which was given to those parties never vested in A. He made a gift of part of his assets for a consideration moving directly to his wife and children. On such portion of his assets, therefore, he could have realized no gain. . . . . (I-38-509; A. R. M. 177.)

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[39] See page 532.

[Former Procedure]

Under the 1918 law an exchange of property was regarded as a closed transaction (a) if the property received was the "equivalent of cash," except that (b) if securities were received in a reorganization of "no greater aggregate par or face value" than those exchanged, the transaction was deemed not to be closed; (c) if the aggregate par of the securities received in a reorganization was greater than the par of those exchanged, the transaction was deemed to be closed.

The gain in (a) was the excess of the "fair market value" of the property received over the cost, or March 1, 1913, value, of the property exchanged.

The gain in (c) was (1) the excess par value of the securities received in exchange over the par of those exchanged, or (2) the excess "fair market value" over the cost or March 1, 1913, value, respectively. That is, the taxable profit is (1) or (2), whichever is lower.

The subject is treated at great length in *Income Tax Procedure,* 1921, in Chapters XIV and XV. Space does not permit the inclusion of old rulings and comments in this volume.

CHAPTER XXII

INCOME FROM GAINS UPON SALE OR EXCHANGE OF PROPERTY—COMPUTATION OF GAIN AND TAX

Chapter XXI discusses the conditions under which a sale or exchange is deemed to be a closed transaction, the results of which must be accounted for in an income tax return. This chapter deals with the rules governing the measurement of the gain and the computation of the tax in such transactions as are deemed to be completed within the meaning of the law. It also deals with the determination of the base from which to measure gain from subsequent sales in those transactions deemed not to be closed at the time.

Basis for Ascertaining Gain or Loss When Appreciation of Property Values Is Realized

The 1921 law made numerous changes in the basis for determining gain or loss when appreciation is realized.[1] The two main bases are cost (for property acquired after February 28, 1913) and fair market value at March 1, 1913, (for property acquired prior thereto). The various exceptions are succinctly stated in the law under the two main classifications of property acquired after and before March 1, 1913.

When property is acquired after February 28, 1913.—

LAW. Section 202. (a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; . . . .

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[1] [Former Procedure] For text of 1918 and prior laws, regulations thereunder and criticisms of the regulations, see *Income Tax Procedure*, 1921, pages 404-425.

The exceptions noted in the statute are:

1. Property which is properly subject to inventory.[2]
2. Gifts, after December 31, 1920.[3]
3. Property acquired by bequest, devise or inheritance.[4]

When property is acquired before March 1, 1913.[5]—

Law. Section 202. . . . . (b) The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a) [that is to say, cost is the basis]; but—

(1) If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall be the excess of the amount realized therefor over such fair market price or value;

(2) If its fair market price or value as of March 1, 1913, is lower than such basis, the deductible loss is the excess of the fair market price or value as of March 1, 1913, over the amount realized therefor; and

(3) If the amount realized therefor is more than such basis but not more than its fair market price or value as of March 1, 1913, or less than such basis but not less than such fair market price or value, no gain shall be included in and no loss deducted from the gross income. . . . .

The foregoing follows the decision of the Supreme Court,[6] retroactive to 1913. If an excessive tax has been paid because of the use of a basis other than that indicated by the above quoted section of the law, claim for refund should be made.

Regulation. For the purpose of ascertaining the gain or loss from the sale or exchange or property, the basis is the cost of such property, or in the case of property which should be included in the inventory, its latest inventory value. But in the case of property acquired before March 1, 1913, when its fair market value as of that date is in excess of its cost, the gain to be included in gross income is the excess of the amount realized therefor over such fair market

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[2] Section 202 (a-1).

[3] Section 202 (a-2). See page 616.

[4] Section 202 (a-3). See page 622.

[5] **[Former Procedure]** The basis stated in section 202 (b) of the 1921 law was held by the Attorney General, in an opinion dated August 23, 1922, to be retroactive to 1916, 1917 and 1918 laws. (I-37-495; Op. A. G. 4.)

[6] *Goodrich v. Edwards,* 255 U. S. 527, 41 Sup. Ct. 390, 65 L. Ed. 758.

value. Also in the case of property acquired before March 1, 1913, when its fair market value as of that date is lower than its cost, the deductible loss is the excess of such fair market value over the amount realized therefor. No gain or loss is recognized in the case of property sold or exchanged (*a*) at more than cost but at less than its fair market value as of March 1, 1913, or (*b*) at less than cost but at more than its fair market value as of March 1, 1913. . . . .

. . . . If the taxpayer can not determine the cost of securities purchased prior to March 1, 1913, because of the loss, destruction or failure to keep records, the value of the securities at the date or approximate date of acquisition may be used in determining the cost basis for purposes of computing the gain or loss from the sale of the securities. When the date or approximate date of acquisition is unknown, no general rule can be stated for determining the cost value of such securities. Each case must be considered separately upon its own facts. . . . . (Art. 1561.)

The following illustrative examples, given in article 1561, indicate the application of the law quoted above:

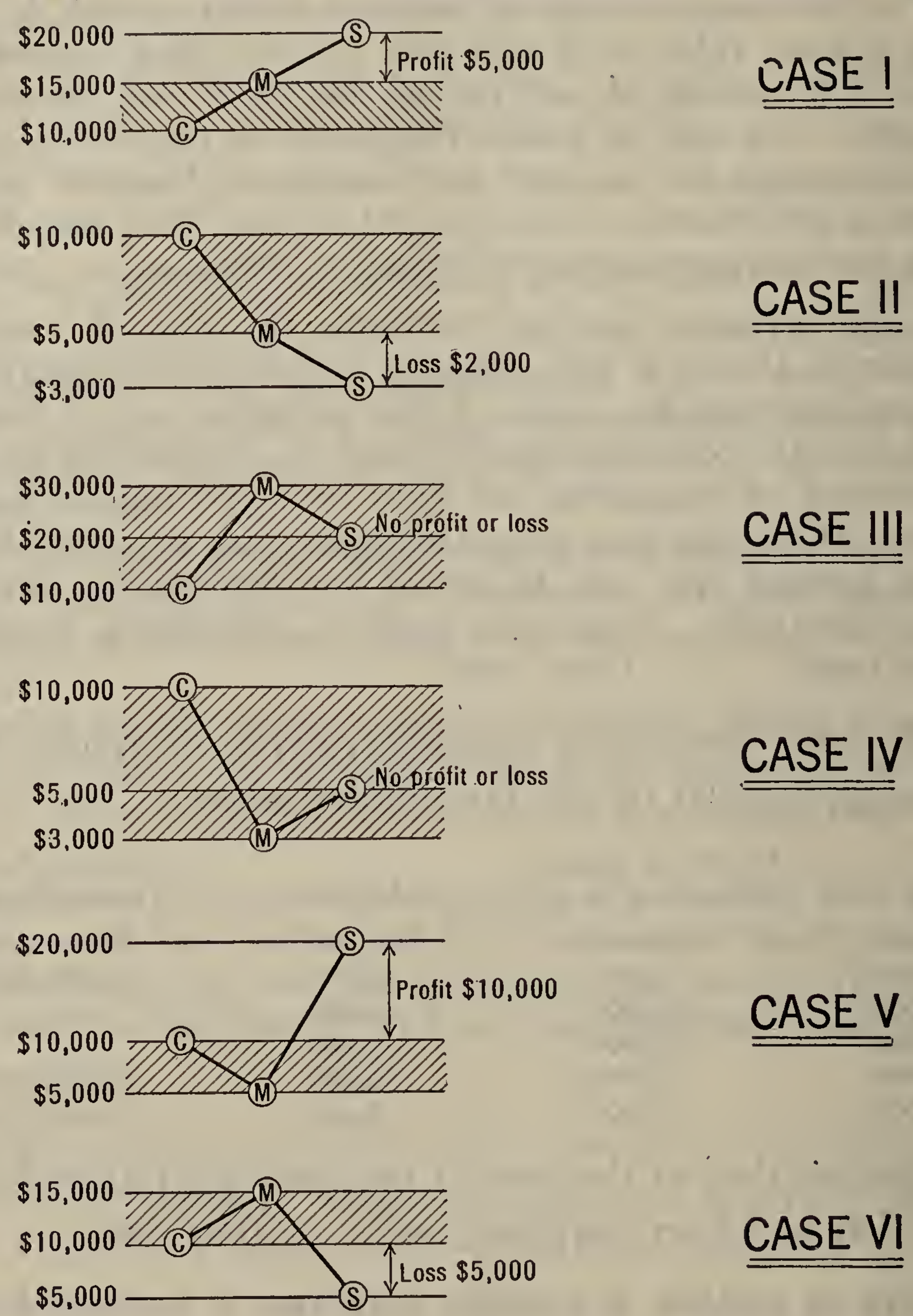
Case	*Cost*	*Market Value at March, 1, 1913*	*Sale Price*	*Taxable Profit or Deductible Loss*
I	$10,000	$15,000	$20,000	$5,000 profit
II	10,000	5,000	3,000	2,000 loss
III	10,000	30,000	20,000	....
IV	10,000	3,000	5,000	....
V	10,000	5,000	20,000	10,000 profit
VI	10,000	15,000	5,000	5,000 loss

It is apparent that in the case of property sold after March 1, 1913, which had been acquired prior to that date:

1. There is neither a taxable gain nor a deductible loss when the selling price lies between cost and market value as of March 1, 1913, and
2. When selling price is greater than both cost or market value, or when less than both cost or market value, the taxable gain or deductible loss is the lesser amount by which the selling price differs from cost or market value as of March 1, 1913.

The chart reproduced on page 566 shows in graphic form how the appreciation is measured.

The author's attention was recently called to a circular sent out by a brokerage house with the suggestion that they



EXPLANATION

C = COST PRICE, M = FAIR MARKET VALUE AS OF MAR. 1, 1913, AND S = SELLING PRICE

THE DIFFERENCE BETWEEN C AND M IS A ZONE OF NO PROFIT OR LOSS, AND HAS BEEN SHADED IN THE DIAGRAMS ABOVE.

IF THE SELLING PRICE FALLS WITHIN THIS AREA, THERE IS NO TAXABLE GAIN OR LOSS.

IF THE SELLING PRICE IS OUTSIDE THE SHADED AREA, THE GAIN OR LOSS IS MEASURED ONLY FROM THE NEARER MARGIN OF SUCH AREA.

would "calculate the loss which you may register upon any of the securities you now hold." An example was given of a client who sold 500 shares of a certain stock at 85. The circular stated "On March 1st, 1913, the *date fixed by the Government for valuation purposes for any* stocks acquired before that date, this stock had a market value of 135"—a loss of 50 points, or $25,000. The circular failed to state that the basis for computing such loss is cost or value March 1, 1913, whichever is lower. If the stock had been acquired originally for 85, no part of the $25,000 "loss" would be deductible.

The foregoing official illustrations do not show the effect of depreciation accrued from March 1, 1913, to date of sale, which must always be considered.

REGULATIONS. . . . . In every case, however, in ascertaining the gain, the cost of the assets, including any expenditures properly charged to capital account, or the fair market value as of March 1, 1913, of the assets acquired prior thereto, should first be reduced by the amount of depreciation, obsolescence, depletion, sustained and allowable, as a deduction in computing net income. . . . . (Art. 546.)

. . . . In any case proper adjustment must be made in computing gain or loss from the exchange or sale of property for any depreciation or depletion sustained and allowable as a deduction in computing net income; the amount of depreciation previously charged off by the taxpayer shall be deemed to be the true depreciation sustained unless shown by clear and convincing evidence to be incorrect. . . . . (Art. 1561.)

. . . . (g) "Depletion or depreciation sustained": . . . . in arriving at profit or loss from sale, means depletion or depreciation allowed, based on value as at basic date except where value as at basic date is a discovery value, in which case the depletion sustained is that based on value as of March 1, 1913, or cost if acquired after that date; . . . . (Art. 201.)

It is necessary to compare cost depreciated to date of sale with selling price, as well as to compare value at March 1, 1913, depreciated to date of sale with selling price.

With these two elements to be subtracted from selling price taken into consideration, the general rule laid down

in the law, and indicated by the recent decision of the Supreme Court,[7] viz., that there can be no taxable gain unless selling price exceeds cost, is applied. Application of this rule means that there is no taxable gain unless selling price exceeds cost depreciated to date of sale; i.e., there cannot be any gain unless the seller gets more than the value he would be assumed to have if there is taken into account depreciation upon cost to the date of sale.

The following examples and comments illustrate the principles involved.

(Life of asset, 20 years from 1908)
(Life of asset, 15 years from 1913)

CASE 1

1908 Cost	$10,000	
Less: Depreciation on cost 1908-1921	7,000	$ 3,000
1921 Sales price		$20,000
March, 1913, value	$15,000	
Less: Depreciation 1913-1921 on March, 1913, value	9,000*	6,000
1921 Net gain		$14,000

*To make the illustrations simpler, 1913 has been considered as a full year.

The foregoing shows the advantage of revaluation at March 1, 1913. The net gain based on depreciated cost would be $17,000; i.e., $20,000—($10,000—$7,000).

CASE 2

1908 Cost	$10,000	
Less: Depreciation on cost 1908-1921	7,000	$ 3,000
1921 Sales price		$20,000
March 1, 1913, value	$ 9,000	
Less: Depreciation 1913-1921	5,400	3,600
1921 Taxable gain		$16,400

The foregoing shows the advantage of using March 1, 1913, net value. The original cost is greater than the March 1, 1913, value, but the *depreciated* value at March 1, 1913, is greater than the *depreciated* cost. Therefore the higher figure is used.

[7] *Walsh v. Brewster*, 255 U. S. 536, 41 Sup. Ct. 392, 65 L. Ed. 762.

Had the depreciated cost been used, the net gain would have been $17,000; i.e., $20,000—($10,000—$7,000).

CASE 3

March, 1913, value	$ 5,000	
Less: Depreciation 1913-1921	3,000	$ 2,000
1921 Sales price		$20,000
1908 Cost	$10,000	
Less: Depreciation on cost 1908-1921	7,000	3,000
1921 Taxable gain		$17,000

The foregoing shows the advantage of ignoring March 1, 1913, value when it is lower than cost. The net gain, based on depreciated March 1, 1913, value, would be $18,000; i.e., $20,-000—($5,000—$3,000).

It might be urged that the only depreciation which need be deducted is on cost to February 28, 1913, and on the March 1, 1913, value subsequently.

In case 3 the depreciation to February 28, 1913, on cost is	$ 2,500
Depreciation 1913-1921 on depreciated value	3,000
Total depreciation	$ 5,500
Original cost	10,000
Net cost	$ 4,500
Sales price	20,000
Net gain	$15,500

In the opinion of the author, the foregoing method is not sound. It is true that

The depreciation deduction for income tax purposes is	$ 3,000
Instead of on cost	4,500
An apparent loss of	$ 1,500

The law states that taxpayers may invoke the original cost basis instead of March 1, 1913, value, provided such basis prevents the imposition of the tax on unrealized gains. But there is nothing in the law which states that the privilege of ignoring the March 1, 1913, value may be invoked to reduce an unjust tax and at the same time there may be ignored the

inevitable depreciation which is going on. If cost was $10,000 and the effective life is twenty years, at the end of fourteen years there is a reduction in the capital of $7,000. The taxpayer receives that benefit annually as a return of his capital invested. If he wishes to ignore the March 1, 1913, revaluation in order to reduce his taxable gain from $18,000 to $17,000, he should not also be able to use partially the March 1, 1913, value and reduce the taxable gain from $17,000 to $15,000.

In 1908 there was no federal income tax law. From 1909 to 1912 corporations would have been able to deduct depreciation on $10,000. *Individuals would not.* After 1913 individuals and corporations could deduct depreciation on $5,000. Therefore the factor of the depreciation allowance granted under federal laws can hardly be a factor when the sole question involved is to secure the benefit of a departure from the March 1, 1913, value.

The regulations (articles 201,[8] 546,[9] and 1561[10]) and at least one ruling[11] apparently require taxpayers to deduct only the depreciation or depletion "allowable." A very recent ruling, however, appears to sustain the author's position with reference to the proper application of depreciation to both cost and March 1, 1913, valuation in determining the taxable profit realized or deductible loss sustained upon the sale of depreciable property which had been acquired prior to March 1, 1913.

RULING. . . . . The taxpayer purchased depreciable property in 1905 for $70,000. The appraised value of the property as of March 1, 1913, was $79,000. The depreciated value at the time of sale, based on cost, was approximately $40,000, and based on the appraised value as of March 1, 1913, approximately $65,000. The question to be determined is whether or not the taxpayer realized a taxable gain or suffered a deductible loss upon the sale of the property in 1917 for $47,000.

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[8] See page 567.
[9] *Ibid.*
[10] *Ibid.*
[11] See I. T. 1178, *Income Tax Procedure,* 1922, pages 579, 580.

This office compares the selling price, $47,000, with cost and March 1, 1913, value, depreciated in both cases to the date of sale, and from such comparison concludes that there was neither taxable gain nor deductible loss. The taxpayer maintains (1) that its ostensible loss was the difference between $70,000, cost, and $47,000, selling price, or $23,000; (2) that since the value as of March 1, 1913, was in excess of the cost, it follows that all of this loss was sustained since 1913; and (3) that the amount of deductible loss is the difference between $23,000 and the depreciation sustained since March 1, 1913, $15,000, or $8,000. . . . .

The rule for the determination of gain or loss, including the requirement of proper adjustment for depreciation in every case, was embodied in article 1561 of Regulations 62, and illustrations were added, with the explanation that "To avoid complexity no adjustment has been made in these examples for depreciation or depletion." The third illustration is an example of the provision in section 202 (b) 3 of the Revenue Act of 1921 that no gain shall be included in the gross income "if the amount realized therefor is more than such basis (cost) but not more than its fair market price or value as of March 1, 1913." This illustration is reproduced here, with the values involved in the present case (including proper adjustments for depreciation) added in brackets:

Cost.	Fair market value Mar. 1, 1913.	Sale Price.	
$10,000........ [$40,000]......	$30,000 [$65,000]	$20,000 [$47,000]	No taxable gain or deductible loss. Reason: A gain on whole transaction, which gain is attributable to period prior to Mar. 1, 1913.

It is true that the sale took place in 1917, four years before the Revenue Act of 1921 was enacted, but since both the statutory provision and article 1561 of Regulations 62 were mere interpretations and applications of the . . . . decisions of the Supreme Court, it is believed that they are in point. The proposed ruling in the present case is based upon *Goodrich v. Edwards* and *Brewster v. Walsh*, or rather the necessary implications of those cases as set forth in article 1561 of Regulations 45 as amended by T. D. 3206 and in article 1561 of Regulations 62. The property in those cases was not depreciable property. Likewise, for the sake of simplicity, the valuations used in the examples given in Regulations 62 are not depreciated, although it is expressly stated that in every case proper allowance must be made for depreciation. To depreciate the March 1, 1913, value, but not the cost, would be to compare unlike things, as would also be the case if the value as of March 1, 1913, depreciated to date of sale, were compared with cost in 1905, depreciated not from date of purchase but from March 1, 1913. The real economic result of every sale of depreciable property is obtained by comparing

the sale price with the cost, depreciated to date of sale, and all that the law and regulations require is that this result be qualified or corrected by another comparison of sale price with the March 1, 1913, value. Following this procedure in the present case, we find by the first comparison an actual or economic gain of approximately $7,000, which, however, is not taxable because the second comparison (sale price with depreciated March 1, 1913, value) shows a loss; which simply means that on the whole transaction there was a gain but that the gain is attributable to the period prior to March 1, 1913, and therefore is not taxable. . . . . (I-46-586; I. T. 1494.)

CASE 4

1908 Cost	$10,000	
Less: Depreciation 1908-1921	7,000	$3,000
1921 Sales price		$8,000
March 1, 1913, value	$15,000	
Less: Depreciation 1913-1921	9,000	6,000
1921 Taxable gain		$2,000

As in case 1, the foregoing shows the advantage of using March 1, 1913, value even though the sales price is less than the original cost and also less than the value at March 1, 1913. The *depreciated* March 1, 1913, value at date of sale being greater than the *depreciated* cost, the higher figure is used in computing the profit. Had depreciated cost been used the profit would be $5,000; i.e., $8,000—($10,000—$7,000).[12]

CASE 5

March 1, 1913, value	$15,000	
Less: Depreciation 1913-1921	9,000	$6,000
1921 Sales price		$5,000
1908 Cost	$10,000	
Less: Depreciation 1908-1921	7,000	3,000
Realization of March, 1913, value, not taxable		$2,000

In the foregoing case there is no gain or loss because sales price lies between depreciated cost and depreciated March 1, 1913, value. In this case the book profit of $2,000 is not taxable. The sales price, $5,000, is more than depreciated cost,

[12] See C. B. I-1, page 31; I. T. 1178.

$3,000 ($10,000—$7,000), but less than depreciated March 1, 1913, value, $6,000 ($15,000—$9,000).

CASE 6

March 1, 1913, value	$ 4,500	
Less: Depreciation	2,700	$1,800
1908 Cost	$10,000	
Less: Depreciation 1908-1921	7,000	$3,000
1921 Sales price		2,500
Loss sustained based on cost (not deductible)		$ 500

The foregoing is similar to case 5 in that the sales price lies between *depreciated* cost and *depreciated* March 1, 1913, value, hence there is no taxable gain or loss. In case 6 the depreciated cost is higher than the depreciated March 1, 1913, value—the converse of case 5. (See I. T. 1494, quoted on page 570.)

CASE 7

1908 Cost	$10,000	
Less: Depreciation 1908-1921	7,000	$3,000
March 1, 1913, value	$ 5,000	
Less: Depreciation	3,000	$2,000
1921 Sales price		1,000
Deductible loss		$1,000

The foregoing is the same as case 3, except the selling price is *less* than depreciated cost and less than the depreciated March 1, 1913, value. The *lesser* value is used in computing the loss.

CASE 8

March 1, 1913, value	$15,000	
Less: Depreciation 1913-1921	9,000	$6,000
1908 Cost	$10,000	
Less: Depreciation 1908-1921	7,000	$3,000
1921 Sales price		1,000
Deductible loss		$2,000

The foregoing is the converse of case 7, in that the depreciated cost is *less* than the depreciated March 1, 1913, value. As in case 7, the *lesser* value is used in computing the loss.

No adjustment for depreciation when residence of taxpayer is sold.—

Ruling. A taxpayer occupied as a residence a part of a building he purchased before 1913 and rented the other part. In determining the gain from a sale in accordance with article 1561, the amount representing depreciation to be added to the selling price is that sustained on the part of the property used for rental purposes. No depreciation may be considered with respect to that portion of the property used for residential purposes by the taxpayer. (C. B. 5, page 51; Digest O. D. 1026.)

The foregoing ruling works out in favor of taxpayers who sell their residences. The deduction of depreciation decreases the book value of the asset and correspondingly increases the gain.

Application of "tax-free" distributions.—If distributions have been received from earnings accumulated prior to March 1, 1913, or from appreciation at that date, the basis prescribed by section 202, as set forth in this chapter, must be reduced by such "tax-free" distribution in case of loss.[13] In case of gain, however, the "tax-free" distributions are ignored.[14]

Liquidating dividends[15]—Treatment of.—Distributions may be received which are neither from earnings accumulated since or prior to March 1, 1913, nor from appreciation at that date, such as payments in partial liquidation of the original capital. Such distributions serve to reduce the basis prescribed by section 202, treated in this chapter. A distribution from appreciation *after* March 1, 1913, would not be applied against, nor reduce, the basis prescribed by section 202.

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[13] Section 201 (b).
[14] For full discussion, see Chapter XXXIV.
[15] See section 201 (c) and Art. 1544.

Surplus arising from reappraisals is not taxable income.—Increased valuations arising from the writing up of book values are not subject to tax, unless the taxpayer has adopted the inventory method as prescribed by sections 202 (a-1)[16] and 203. In certain cases it is customary and desirable for dealers in securities and similar property to inventory their assets annually. When securities, etc., are stock-in-trade, the best accounting practice requires inventories. But it is not good accounting practice to consider that revaluations of capital assets are equivalent to inventories. This is demonstrated by the practice of accountants who refuse to credit the surplus arising from revaluations of capital assets to the current income or earnings account.

Revaluations as of March 1, 1913, should, however, be used as bases for depreciation and depletion charges, and this requires that the appraisals be entered in the books. Property accounts will be debited and "surplus arising from reappraisement of property" will be credited. The latter account is equivalent to a capital surplus account, excepting that part of the appreciation which may subsequently be realized. Such realized appreciation should then be transferred to an account which on a balance sheet would be called "earned surplus." In order to avoid its inclusion as income for the taxable year, the amount on the books should be credited to "surplus earned prior to March 1, 1913."

Written-up book values as of effective date of law never taxable.—The courts have consistently held that, under both the 1909 and the 1913 laws, increases in the value of property, to be subject to the tax, must have occurred during the period when the law was effective. The 1916, 1917, 1918 and 1921 laws, it will be recalled, specifically designate March 1, 1913, as the date from which appreciation, which is taxable when realized, shall be measured.

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[16] For discussion of inventory valuation, see Chapter XIX.

Supreme Court decisions regarding taxation of appreciation in property values.—The Supreme Court decisions bearing on the taxation of increases in property values may be summarized as follows:

Cases under the 1909 law.—In *Doyle v. Mitchell Brothers Company,*[17] where lands had appreciated in value at December 31, 1908, the court held that "when the act took effect, plaintiff's timber lands, with whatever value they then possessed, were a part of its capital assets. . . . ." Also to the same effect is *Hays v. Gauley Mountain Coal Company,*[18] decided by the Supreme Court on the same day.[19]

Revaluations as of January 1, 1909, however, are of interest only when there was a realization of such appreciation prior to February 28, 1913.

Cases under the 1913 law.—In *Lynch v. Turrish,*[20] the taxpayer received in cash double the par value of stock held by him in a lumber company, the distribution being made upon the surrender of the stock, after which the company went out of business. This distribution was held to be "a return to him (Turrish) of the value of his stock . . . . and at a price that represented its intrinsic value at and before March 1, 1913, when the act took effect. . . . ."

Basis when shares of same issue are bought and sold at different dates.—Securities owned by a dealer may be inventoried[21] and profits may be ascertained on the basis of the valu-

[17] 247 U. S. 179, 38 Sup. Ct. 467, 62 L. Ed. 1054. See also *U. S. v. Guggenheim Exploration Co.,* 238 Fed. 231; also *Baldwin Locomotive Works v. McCoach,* 221 Fed. 59.

[18] 247 U. S. 189, 38 Sup. Ct. 470, 62 L. Ed. 1061.

[19] See also *U. S. v. C. C. C. & St. L. Railway Co.,* 247 U. S. 195, 38 Sup. Ct. 472, 62 L. Ed. 1064.

[20] 247 U. S. 221, 38 Sup. Ct. 537, 62 L. Ed. 1087. For discussion of Supreme Court decisions affecting taxability of dividends in prior years from appreciation at March 1, 1913, see Chapter XXVII and *Income Tax Procedure* 1922, page 586, footnote 22.

[21] See page 506. Banks and financial institutions are required to account for profits on securities in the same fashion as individuals, except where the bank maintains a branch or department for dealing in securities.

ations thus determined. Other securities are to be valued in accordance with the following procedure:

Regulation. When shares of stock in a corporation are sold from lots purchased at different dates and at different prices and the identity of the lots can not be determined the stock sold shall be charged against the earliest purchases of such stock. The excess of the amount realized on the sale over the cost of the stock will constitute gain. However, the gain to be included in gross income in the case where the stock was acquired before March 1, 1913, when its fair market value as of that date is in excess of its cost, is the excess of the amount realized by the sale over such value. No gain is recognized when stock is sold at more than its cost but at less than its fair market value as of March 1, 1913. In the case of stock in respect of which any stock dividend was paid, the cost of each share of such stock shall be ascertained as specified in article 1548. . . . . (Art. 39.)

The theory of this regulation is wrong. When different purchases of the same issue of stock are made the actual result is an average cost. When a taxpayer buys 100 shares of a stock at 80 and later buys 100 shares at 60, he owns 200 shares at 70 and any subsequent accounting should be based on the average. There are difficulties in the application of the average rule when the certificates for the shares can be identified because there may be an actual intention on the part of the taxpayer to separate the transactions. The exercise of the right to select the certificates to be sold, even though not in conflict with the regulations, may defeat the intention of the law.

Computation of gain when "rights," or stock affected by rights, are sold.—Late in 1922 the Treasury amended article 39 of Regulations 62 (which held that the entire proceeds from the sale of rights was income) to bring the regulations into accord with the decision of the Supreme Court[22] in May, 1922, which held that the value of the right is not income. The court held that on the sale of rights part of the proceeds may be taxable income. The decision establishes the

[22] *Miles v. Safe Deposit & Trust Co. of Baltimore,* 66 L. Ed. ——. See page 548.

basis for determining what part if any is gain or loss. The court worked out the profit as follows:

Cost to the taxpayer of one share of stock	$710.00
Cost of exercising right to buy one share	150.00
Total cost of two shares	$860.00
Cost of one share	$430.00
And in the words of the district court (273 Fed. 822): " . . . . if the right was sold, the price really received for the new share was $150 more than the sum paid to the seller, which in the case at bar was $358.48. That was equivalent to $508.48 for a fully paid for share, ..."	
Sales price therefore is	$508.48
Profit on sale of right	$ 78.48

In conformity with the above, the following was added to article 39, and while the language is quite involved, the guiding principle is similar to that governing stock dividends:[23]

REGULATION. . . . . The amount of taxable gain derived or deductible loss sustained from the sale by a stockholder of the right to subscribe or from the sale of the stock with respect to which the right is issued shall be determined as provided in article 1561, after the cost or both the cost and fair market value as of March 1, 1913, if acquired prior thereto of both the old shares and the right is determined in accordance with the following rule:

Where the right issued relates to new stock of substantially the same character or preference as the stock with respect to which the right is issued, the cost of each share of the old stock and the right to subscribe to each share of the new (or, if acquired prior to March 1, 1913, the fair market value as of that date) will be the quotient of the cost (or such fair market value) of the old shares of stock, plus the subscription price of the new shares of stock, divided by the sum of the number of the old shares and the number of new shares covered by the right. In computing the gain from the sale of the right in accordance with article 1561 the price for which sold shall be considered the sum of the subscription price of the new shares and the selling price of the right. The above rule for computing the gain from the sale of the right to subscribe to stock is subject to the limitation that the gain so computed shall not exceed the amount for which the right is sold; in any case in which this limitation is applied, the gain or loss from the subsequent sale of the stock with respect to which the right was issued shall be determined as if no right to subscribe had been issued with respect to it. Where the stockholder

[23] For illustrations, see Chapter XXVIII.

exercises his right to subscribe to new stock of substantially the same character or preference as the stock with respect to which the right is issued, the cost of the old and new shares (or, if acquired prior to March 1, 1913, the fair market value as of that date) will be the quotient of the cost of the old shares, plus the subscription price of the new shares, divided by the total number of the old and new shares. Where the right issued deals with stock in whole or in part of a character or preference materially different from the stock with respect to which the right is issued, or where the stock with respect to which the right is issued was purchased at different times and at different prices, and the identity of the lots can not be determined, or where the stock with respect to which the right is issued was purchased at different times and at different prices and the stock right issued with respect to such stock can not be identified as having been issued with respect to any particular lot of such stock, the computation of the gain from the sale of the old shares or the right in cases where the right is sold or from the sale of the old or new shares in cases where the right is exercised shall be based upon and shall be in accordance with the principles laid down in article 1548 with respect to the computation of the gain or loss from the sale of stock received as a stock dividend. (T. D. 3403, dated October 18, 1922.)[24]

To illustrate the effect of the limitation on the taxable gain referred to in T. D. 3403 above, assume the following:

A owns 30,000 shares costing (after March 1, 1913) $6 per share, or	$180,000
Rights are issued entitling him to subscribe to 1 new share for each 5 shares of old at $15 per share, or 6,000 shares for	90,000
Total 36,000 shares at average cost of $7.50 (if exercised)	$270,000
A sells the rights for $1.50 per share, and is presumed to have received for 6,000 shares the subscription price $15 per share, plus the sale price of the rights, $1.50 per share, or total per share	$ 16.50
Deduct average cost per share as above	7.50
Gain per share	$ 9.00
But the total amount received for each right is only	$ 1.50
Therefore, A reports not more than the amount received for the rights (6,000 × $1.50) or	$ 9,000
Instead of on the basis of average cost of each share (6,000 × $9), or	$ 54,000

[24] [Former Procedure] T. D. 3402, same date, amended Reg. 45, Art. 39, in almost identical language.

In other words, the effect is to limit the gain to the amount received from the sale of the rights. The gain may be less than that amount, depending on the cost of the old shares, but it can never be more.

Exchange of insurance policies—calculation of profit.—When a taxpayer takes out a new insurance policy and the new policy has a "readily determinable cash value," the Treasury holds that a gain "may" result from the exchange.[25]

"Discovery value" not permitted as basis for computation of gain.—In computing gain or loss from the sale of mines, oil and gas wells, discovered after March 1, 1913, the Treasury has held[26] that the "discovery value" may not be used as a basis, on the principle that section 202 of the law fixes the basis, in case of sale, as cost (where the property was acquired after March 1, 1913). It distinguishes this basis from the "discovery value" allowed for depletion purposes, and cites in support of such a view the provisions in sections 211 (b) and 337 of the 1918 law[27] limiting the surtax and excess profits tax in case of sale of such properties to 20 per cent of the selling price, which were inserted to relieve the hardship which would be inflicted on a "discoverer" if he were to sell his property shortly after making the discovery and be obliged to pay heavy surtaxes thereon. Section 211 (b) of the 1921 law contains a similar provision limiting the surtax on sales of such property for 1922 and succeeding years to 16 per cent of the selling price.[28]

Basis determined by value, not by nominal cost—bankruptcy sale.—The following ruling under the 1918 law is of interest because the basis for computing profit or loss on sub-

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[25] C. B. 3, page 54; Sol. Op. 55. For text of ruling, see *Income Tax Procedure*, 1922, page 555.

[26] C. B. 3, page 44; Sol. Op. 26.

[27] The ruling was made under the 1918 law.

[28] For discussion of dividends from depletion reserve as a return of capital, see page 731 *et seq.*

sequent sale was the value of the assets in the hands of the trustee.[29]

RULING. A creditors' committee appointed to reorganize an insolvent corporation bid in at the bankruptcy sale the assets of the bankrupt corporation for the minimum amount required in order to secure the assets, which was less than the total amount of the claims assigned to the committee by the creditors. Funds to pay nonparticipating creditors were raised by pro rata subscriptions. The assets so acquired were sold at a price in excess of the amount bid but for less than the total amount of the assigned claims.

Held, that for the purpose of determining gain or loss, the purchase price of the property to the committee was not the bid price but was the value of the claims held by it plus the cash paid to nonparticipating creditors. The value of the claims for this purpose is not their face value but their actual value, which would be determined by the value of the assets in the hands of the trustee available for distribution to the creditors. Taxable gain would result on the sale by the creditors' committee if the price received by it was greater than the actual value of the claims held by the committee at the time the assets were acquired plus the cash paid to nonparticipating creditors. (C. B. I-1, page 28; Digest I. T. 1292.)

Inventory method not applicable.—The measurement of gain in the case of property subject to inventory has been adequately discussed in an earlier chapter.[30] As to other property, the law plainly designates cost as the base from which to measure appreciation in the case of property acquired on or after March 1, 1913, and the value on that date for property acquired prior thereto, with the exceptions previously noted.

Section 203 of the law grants to the Commissioner full authority to require taxpayers to inventory their assets, so long as the basis prescribed conforms "to the best accounting practice in the trade or business" and "as most clearly reflecting the income." It would seem that there is a very definite limitation upon the power of the Commissioner because it is not customary in any trade or business to inven-

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[29] See page 561 where purchase of assets by bondholders is discussed.
[30] See Chapter XIX.

tory annually or periodically the capital assets. The inventory method is used only with trading assets. Although it might be highly desirable, no specific authority is given to prescribe inventories for those not engaged in trade or business.

Should carrying charges be added to cost of property?— The Treasury has held that taxes paid in prior years, which were not deducted because the taxpayer had not sufficient income to necessitate the filing of a return, may not be considered as additional cost of the property. (C. B. I-1, page 28; I. T. 1188.)

In C. B. I-1, page 30; I. T. 1338, the question was raised as to whether this ruling superseded T. D. 2005, which provided that carrying charges could be capitalized to the extent that such charges exceed the income from such property. The Treasury holds that carrying charges paid subsequent to January 1, 1909, cannot be capitalized.

The Treasury has reiterated its position in the matter of capitalizing carrying charges in I-49-621; I. T. 1517.

In the author's opinion, the procedure outlined in T. D. 2005 is still applicable as it represents correct accounting procedure. Before property is on an income-producing basis, there cannot be any operating loss, which the Treasury's present position would demand. Hence the expenditures for interest, taxes, etc., must be added to the cost of the property until such time as it has passed beyond the unimproved or development stage. After the property has been developed, carrying charges should be written off as an expense and not capitalized.

If further confirmation of the author's position were required, reference to article 231 would demonstrate that in the case of timber lands, the Treasury holds that carrying charges are to be capitalized until the property is on an income-producing basis. No distinction in favor of timber lands can be made; the principle applies to all income-producing property.

Basis for Ascertaining Gain or Loss When Property Disposed of Was Received in a Continuing Transaction

In the preceding chapter the determination of whether a transaction is closed or continuing has been treated.[31]

When the transaction is deemed to be continuing, the 1921 law specifies how the basis for computing profit on subsequent sale is to be ascertained, as follows:[32]

1. The general rule is that the cost or March 1, 1913, value of the old property exchanged is assigned to the new property received [section 202 (d-1)].
2. Property "replaced" is assigned a proportionate part of the cost of the old property destroyed in the ratio of amount expended to amount recovered [section 202 (d-2)].[33]
3. In the case of "wash sales" the cost or March 1, 1913, value of the securities sold, or a *pro rata* part where only a part of the transaction is deemed to be a "wash sale," is assigned to the securities purchased [section 202 (d-3)].[34]
4. When (a) part cash or/and property having a readily realizable market value, and (b) part property having no readily realizable market value are received, the amount of cash or/and property having a readily realizable market value serves to reduce the original cost or March 1, 1913, value of the old property exchanged [section 202 (e)], but
5. When property of the following classes is received, even though it may have a readily realizable market value, no immediate profit is realized:
   (a) Property of a like kind or use,
   (b) Securities received in a "reorganization,"

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[31] For full discussion of transactions deemed not to be "closed," see Chapter XXI.

[32] Section 202 (d) and 202 (e).

[33] For discussion and illustration see Chapter XVIII, and page 585.

[34] The deductibility of losses on "wash sales" is discussed in Chapter XXXIV, and on page 585.

(c) Securities received from an 80 per cent controlled corporation, together with

(d) Cash or property (other than mentioned under (a), (b) and (c)) having a readily realizable market value,

Only the items in (d) serve to reduce the basis of the original cost or March 1, 1913, value.

6. When property is transferred to an "80-per cent controlled corporation" [section 202 (c-3)], the fair value at date transferred to such a corporation apparently may be used as a basis for computing profit on subsequent sale.[35]

Property received takes the place of the property exchanged.—

Law. Section 202. . . . . (d) (1) Where property is exchanged for other property and no gain or loss is recognized under the provisions of subdivision (c), the property received shall, for the purposes of this section, be treated as taking the place of the property exchanged therefor, except as provided in subdivision (e); . . . .

No problem arises when a transaction is deemed not to be closed except that taxpayers who exchange property for other property sometimes neglect to preserve the records which show the original cost. These records are particularly valuable when losses are claimed. Revenue agents are justified in demanding trustworthy records.

Regulation. (*a*) Where property is exchanged for other property and no gain or loss is recognized under articles 1564 or 1566 the property received shall for the purpose of determining gain or loss from its subsequent sale be treated as taking the place of the property exchanged therefor. . . . . For exchange of property acquired prior to March 1, 1913, see article 1561. If property is exchanged for two kinds of property and no gain or loss is recognized under articles 1564 or 1566 the cost of the original property should be apportioned, if possible, between the two kinds of property received in exchange for the purpose of determining gain or loss upon subsequent sale. If no fair apportionment is practicable, no profit on any subsequent sale of any part of the property received in

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[35] See further, page 551 *et seq.*

exchange is realized until out of the proceeds of sale shall have been recovered the entire cost of the original property. When securities of a single class are exchanged for new securities of different classes so that no gain or loss is realized under the provisions of paragraph (*b*) of article 1566, for the purpose of determining gain or loss on the subsequent sale of any of the new securities the proportion of the original cost, or other basis, to be allocated to each class of new securities is that proportion which the market value of the particular class bears to the market value of all securities received on the date of the exchange. For example, if 100 shares of common stock, par value $100, are exchanged for 50 shares of preferred and 50 shares of common each of $100 par value, and the cost of the old stock was $250 per share, or $25,000, but the market value of the preferred on the date of the exchange was $110 per share, or $5,500 for the 50 shares, and the market value of the common was $440 per share or $22,000 for the 50 shares of common, one-fifth of the original cost, or $5,000, would be regarded as the cost of the preferred and four-fifths, or $20,000 as the cost of common. The same method of computation should be used in the case of stock acquired prior to March 1, 1913, in order to ascertain the proportion of such value to be allocated to each class of new securities on that date and the taxable gain or deductible loss should thereafter be computed in accordance with article 1561. . . . . (Art. 1567.)

Basis when "replacement funds" are established and property lost or destroyed is replaced.—

REGULATION. . . . . (*b*) Where property is compulsorily or involuntarily converted into cash or its equivalent in the manner described in sections 214 (a) (12) and 234 (a) (14) and the taxpayer proceeds in good faith to expend or set aside the proceeds of such conversion in the form and in the manner therein provided, the property acquired shall for the purpose of determining gain or loss from its subsequent sale be treated as taking the place of a like proportion of the property converted. . . . . (Art. 1567.)

Full discussion of "replacement funds" and the treatment of property replaced thereunder, with an illustration of the manner in which the deferment of profit thereon serves to reduce the basis of cost proportionately, will be found in Chapter XVIII.

Basis when loss on "wash sales" is denied.—

LAW. Section 202. . . . . (d) . . . . (3) **Where no deduction is allowed for a loss or a part thereof under the provisions of para-**

graph (5) of subdivision (a) of section 214 and paragraph (4) of subdivision (a) of section 234, that part of the property acquired with relation to which such loss is disallowed shall for the purposes of this section be treated as taking the place of the property sold or disposed of. . . . .

Assume that securities costing in 1915 $100,000, were sold in 1922 for $60,000, registering a loss of $40,000. If $20,000 of this loss were disallowed as arising from a "wash sale" (due, for instance, to a partial repurchase), then the "cost" of one-half of the securities repurchased would be deemed to be one-half of the cost of the securities disposed of, viz., $50,000.

For discussion of losses on "wash sales" and similar transactions, see Chapter XXXIV, "Deductions for Losses."

Effect of receipt of cash (or property other than cash) by former owners.[36]—The following section gives effect to the new provisions of the 1921 law holding certain transactions not to be closed, but for purpose of computing profit on a sub-

[36] **[Former Procedure]** The following decision, rendered February 17, 1922, involved a reorganization in 1916 in which part cash was received by the old stockholders.

Decision. . . . . It is the Government's contention that this transaction . . . . was in substance and in legal effect a sale . . . . at an agreed valuation of $300 a share of which $150 was to be paid in cash and the residue in securities of a new and independent corporation. . . . . The stockholders of the old company, it must be held, sold one-half of their shares of stock to Eastman, Dillon and Company. They received therefor the sum of $150 in cash. They had no option of taking $300 in cash or of getting anything else, except an increased number of shares of reduced par value as a result of the changes in corporate form and organization . . . . it follows that the income derived or gained by plaintiff . . . . is the cash received by him less the cost of each share to him. . . . . (*Stearn v. Weiss, Collector* (not reported), U. S. District Court, Nor. Dist. of Ohio, Eastern Div.)

If each of the old stockholders received for each share of old stock $150 in cash and the balance in new securities, two courses other than that stated in the decision would seem to be open: (1) to apply against the $150 cash received a pro rata part of the cost of the old stock, or (2) to treat the $150 received as if the transaction was continuing, and apply same to reduce the basis of cost of the old stock, as under section 202 (e) of the 1921 law. The court seems to have taken almost the latter view and applied the principle laid down in the 1921 law to the 1916 reorganization.

sequent sale certain adjustments of the original cost or March 1, 1913, value have to be made.

LAW. Section 202. . . . . (e) Where property is exchanged for other property which has no readily realizable market value, together with money or other property which has a readily realizable market value, then the money or the fair market value of the property having such readily realizable market value received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis, shall be taxable to the extent of the excess; but when property is exchanged for property specified in paragraphs (1), (2), and (3) of subdivisions (c) as received in exchange, together with money or other property of a readily realizable market value other than that specified in such paragraphs, the money or the fair market value of such other property received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis, shall be taxable to the extent of the excess. . . . .

The rule laid down in the foregoing section of the law may be stated as follows: When the transaction is not closed, the cash or other property having a readily realizable market value (other than the three exceptions stated) received in exchange is regarded as a return (in whole or in part, as the case may be) of the taxpayer's investment.

The following illustrations show the two applications of the rule, when the transaction is regarded as a continuing one.

CASE I

Land costing (after March 1, 1913) $25,000	is exchanged for	Securities (having no readily realizable market value) Cash $10,000

In the above case the securities are regarded as taking the place of the land, but the cash received $10,000 is applied against the $25,000, so that the "cost" of the securities, upon resale, is deemed to be $15,000.

An example falling under this general heading but containing complications due to purchases of stock at different dates is given in the following ruling:

RULING. The case of the taxpayer involves two blocks of stock purchased at different times and sold together as a part of one transaction. The first block, consisting of 2y shares, was acquired prior to

March 1, 1913, at a cost of $205x$ dollars. The fair market value thereof as of March 1, 1913, was $613x$ dollars. The second block, consisting of $2y$ shares, was purchased immediately prior to the sale in 1920 for $356x$ dollars and was sold at cost. The basis for determining gain or loss from the sale consequently was the March 1, 1913, value of the stock originally purchased and the cost of the stock purchased immediately prior to the sale, which amounted to $969x$ dollars. The sale price was $732x$ dollars, which was $237x$ dollars less than the basis indicated. This difference, however, is not a deductible loss, inasmuch as it is made up entirely of the difference between the fair market value as of March 1, 1913, of the stock originally purchased and the sale price attributable thereto ($376x$ dollars), such sale price being in excess of the cost of such original stock. So far as this case has progressed, therefore, no taxable gain has been realized nor has any deductible loss been sustained. Under the contract there was in addition to the above consideration the promise by the vendee to deliver common stock in a new or a reorganized corporation when, as, and if issued. It follows under the rule announced in *Goodrich v. Edwards* (C. B. 4, p. 40) that no taxable gain will be realized from the sale until the amount realized from such sale of stock exceeds $969x$ dollars, the sum of the fair market value as of March 1, 1913, of the stock purchased prior thereto and the cost of the stock purchased immediately before the sale. This promise to deliver stock constitutes a part of the consideration for the sale. Whatever is realized in money value in respect of such promise must be added to the amount already received in order that it may be determined whether the transaction as a whole, when thus finally completed, shows a taxable gain under the rule referred to. (I-40-531; I. T. 1457.)

CASE II

Land costing (after March 1, 1913) $25,000	is exchanged for	(a) Land[37] or (b) Securities in an 80 per cent controlled corporation[38] or (c) Either one or both of the above two classes, all having a readily realizable market value; and (d) Cash, or securities of a kind different from those in (b) or (c) above, having a readily realizable market value of $10,000

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[37] For discussion of property of a "like kind or use" [section 202 (c-1)], see page 540.

[38] Transfers of property to a corporation in which the transferors control 80 per cent or more of the stock [section 202 (c-3)], are discussed at page 551 *et seq.*

In the second case, while any or all of the two specific classes of property (a) and (b) above may have a readily realizable market value, the receipt thereof is, under section 202 (c), deemed to be a continuing transaction in which neither gain nor loss is recognized. Therefore, only the value of property (d) in the illustration above, $10,000, is regarded as a return on account of the original investment of $25,000, and thus serves to reduce the basis to $15,000 for purpose of computing profit on any subsequent sale of property (a) or (b).

If, in the foregoing illustration, property (d) had an aggregate value of $30,000 instead of only $10,000, a profit of $5,000 would have to be reported for the period during which the transaction occurred, and upon the sale of any of the property (c) or (b) the full amount realized would have to be reported as taxable income.

Case III

Stocks and bonds in company costing (after March 1, 1913) $25,000	are exchanged for	Securities in B Company, in a "reorganization"[39] of A Company, having a readily realizable market value; and Cash $10,000

The third case is also deemed to be a continuing transaction, under section 202 (c), although the securities received in the "reorganization" have a readily realizable market value at the time of their receipt by the taxpayer. The $10,000 of cash, however, is applied against the cost of the original securities, so that upon subsequent sale of the new securities their "cost" is deemed to be $15,000.

Official illustrations.—The official illustrations, together with a tabular statement thereof so that they may be readily followed, are given below:

Regulation. . . . . *Examples.*—(1) A exchanged certain property which he had purchased subsequent to March 1, 1913, for $5,000, for real estate having no readily realizable market value and

[39] "Reorganizations" [section 202 (c-2)] are treated at page 551 *et seq.*

$2,000 in cash. No gain or loss is realized from such exchange. However, if A subsequently sells the real estate, the difference between the amount realized therefor and $3,000, the basis of the property exchanged reduced by the amount of cash received in the exchange, is taxable gain or deductible loss, as the case may be. . . . . (Art. 1568.)

(1) Property, cost (after March 1, 1913) $5,000	is exchanged for	Real estate having no readily realizable market value Cash $2,000

Basis—"cost" of real estate received is $3,000, viz., $5,000—$2,000.

Regulation. . . . . (2) A exchanged certain property which he had purchased subsequent to March 1, 1913, for $14,000, for stock having no readily realizable market value and bonds having a readily realizable market value of $16,000. A realized a taxable gain of $2,000, the amount by which the fair market value of the bonds exceeds the cost of the property exchanged. The entire amount received from the subsequent sale of the stock received in the exchange constitutes taxable income. . . . . (Art. 1568.)

(2) Property, cost (after March 1, 1913) $14,000	is exchanged for	Stock (having no readily realizable market value) Bonds (market value $16,000)

Taxable gain $2,000, viz., $16,000—$14,000.
Basis—new "cost" of stock received is 0.

Regulation. . . . . (3) A, in connection with a reorganization of a corporation, received in place of stock purchased by him subsequent to March 1, 1913, for $9,000, stock in a corporation a party to the reorganization together with cash in the amount of $4,000. No gain or loss is realized from the exchange. However, if A subsequently sells the stock, the difference between the amount received therefor and $5,000, the basis of the old stock reduced by the amount of cash received in the exchange, constitutes taxable gain or deductible loss, as the case may be. . . . . (Art. 1568.)

(3) Stock, cost (after March 1, 1913) $9,000	is exchanged for	Stock in a "reorganization" Cash $4,000

Basis—"cost" of stock received is $5,000, viz., $9,000—$4,000.

Regulation. . . . . (4) A transferred to a corporation, all of the outstanding stock of which was owned by him, property purchased by him subsequent to March 1, 1913, for $40,000, in exchange for stock and $50,000 in cash. A realized from the exchange a taxable gain of $10,000, the amount by which the amount of the cash

exceeds the cost of the property transferred. The entire amount received from the subsequent sale of the stock received in the exchange constitutes taxable income. . . . . (Art. 1568.)

(4) Property, cost (after March 1, 1913) $40,000	is exchanged for	Stock (in a totally owned corporation) at least 80 per cent controlled Cash $50,000

Gain $10,000, viz., $50,000 — $40,000.
Basis—new "cost" of stock received is 0.

REGULATION. . . . . It is assumed in the above examples that the property exchanged was not of a kind properly to be included in inventory. If the property exchanged was acquired prior to March 1, 1913, or by gift, devise, bequest, or inheritance, see articles 1561, 1562, and 1563. (Art. 1568.)

The basis to be used in case of property acquired prior to March 1, 1913, is discussed on page 592 *et seq.*

Property acquired by gift after December 31, 1920, is deemed to have, in the hands of the donee, the same cost or March 1, 1913, value as if still in the possession of the donor.[40] Gifts acquired prior to December 31, 1920, and property acquired by devise, bequest or inheritance are treated on page 616 *et seq.*

Effect of payment of cash in exchange.—Assume that A owns stock costing him $9,000, valued at $10,500, which he exchanges for other stock having a market value of $11,000. He pays B the difference of $500 in cash. The new stock on A's books is considered as costing him $9,500 (i.e., the cost of the old stock $9,000, plus $500 cash paid on exchange).

Computation of gain by transferee corporation.—The general rule that where no gain or loss is recognized under section 202 (c), the property *received* shall be treated as taking the place of the property exchanged therefor is stated in section 202 (d-1). Such a rule would seem to work fairly well in cases covered by 202 (c-1) (investments or productive assets)

[40] See page 617.

also in cases included in 202 (c-2) (reorganizations). But when we come to 202 (c-3) (transfers of property to a corporation, presumably for stock or securities of such transferee corporation) we must consider the problem not only from the aspect of the person who *receives* the stock in exchange, but also from the standpoint of the corporation which *receives* the property for which it issues its stock. Assume that A has securities costing him $100,000 which are now worth $200,000. He forms corporation B to which he transfers such securities in exchange for its entire capital stock, $200,000. Shall corporation B take up these securities on its books at $200,000? If corporation B shortly thereafter sells these securities for $200,000 cash, does the corporation realize a profit? It would seem that the gain arising from sale must be based on the cost to new corporation. But if there are no new interests in the corporation and the transaction is held to be a continuous one, it is hardly equitable to write up the value of the assets.[41] The effect would be to increase the basis upon which gains are computed from the cost of the property to the beneficial owners to higher values in the hands of the same beneficial owners.

Assume that instead of securities in the foregoing illustration, A had transferred to corporation B $200,000 of depreciable property. Should corporation B thereafter charge depreciation on $200,000 or on the old cost to A, viz., $100,000?[42] The law would seem to permit it but the author doubts the propriety of so interpreting the law.

Determination of Fair Market Price or Value at March 1, 1913

It should be noted that the law does not require the determination of "fair market value" on March 1, 1913, but "fair market price or value." If fair market price can be

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[41] See type No. 6 of transactions deemed to be continuing, page 558.

[42] See Chapter XXXVI where depreciation in cases of reorganization is discussed.

ascertained, nothing further is needed. But it must be "fair," that is, representative and not narrow. The sale of a few shares of stock out of thousands is not a fair criterion. In addition the price must meet the common definition of "market," which presumes a willing buyer and a willing seller. If any one of these elements is lacking it becomes necessary to use the alternative provided in the law, viz., "value." Often the Treasury fails to consider the second standard and insists on the first.

No specified method of determining value.—

REGULATION. . . . . What the fair market value of property was on March 1, 1913, is a question of fact to be established by any evidence which will reasonably and adequately make it appear. In the case of property traded in on public exchanges, evidence of actual sales at or about March 1, 1913, or other basic date, affords evidence of value, but it must not be regarded as conclusive. The nature and extent of the sales and the circumstances under which they were made should be considered. Prices received at forced sales or for small lots of property may be and often are no real indication of the value of the amount of property in question. For instance, sales from time to time of a small number of shares of stock is little indication of the value of a large or controlling interest in the corporation.[43] . . . . (Art. 1561.)

Realizations may not occur for many years and it is sometimes difficult because of the lapse of time to determine a fair value as of March 1, 1913.[44] It is advisable, therefore, if sales are at all probable, to give consideration to the factors underlying valuations and to accumulate evidence to establish true values as of that date.

VARIOUS POSSIBLE METHODS OF ESTABLISHING VALUE.—The cost of reproduction is rarely a satisfactory basis for the determination of fair market value as of any date. When applied to the present time we find that many properties are sold for less than it would cost, at present prices, to reproduce them. In many cases during the war, prices were paid far

[43] The last part of article 1561 quoted was added in Regulations 62.
[44] For definitions of "value," see *Income Tax Procedure*, 1920, pages 343, 344.

in excess of reproduction costs. Sales near the valuation date by willing sellers to willing buyers are the best bases of all, but the records of such sales are confined almost entirely to stock and similar exchanges. Reproduction cost may, however, be very useful evidence in establishing fair market value.

The following extract from a charge to a jury which was approved[45] on appeal by the United States Supreme Court may be used as an authoritative guide in determining what is "fair market value."

Decision. The market value of goods is the price at which the owner of the goods, or the producer, holds them for sale; the price at which they are freely offered in the market to all the world; such prices as dealers in the goods are willing to receive, and purchasers are made to pay, when the goods are bought and sold in the ordinary course of trade. . . . The defendant asserts . . . . that the only way to arrive at the market value is to take the cost of production, to compute how much the manufacturer has actually disbursed in producing the goods, and that thus you have the actual market value. The United States, however, maintain that . . . . they are freely offered to all the world, and held at known and established rates; . . . . and at which they are ready to furnish them to all the world. If this latter state of facts be true, then it is evident that the prices at which the producers so hold them are the market prices. . . .

The Treasury's definition of "fair market value" is set forth in a ruling quoted on page 536.

In the case of *Virginia v. West Virginia,*[46] decided June 14, 1915, by the United States Supreme Court, wherein the issue was to determine what proportion of Virginia's indebtedness the new state of West Virginia should pay, it became necessary to make adjustments of certain credits and debits as of January 1, 1861, arising out of the valuation of certain railway stocks and other securities as of that time. Justice Charles E. Hughes, in speaking of stock of Richmond, Fredericksburg and Potomac Railroad Company (one lot amongst the several involved), said:

Decision. The fact, however, that there was no sufficient proof of market value, was not an insuperable obstacle to the making of a

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[45] *Cliquot's Champagne,* 3 Wall. 114, 70 U. S. 114, 18 L. Ed. 116.
[46] 238 U. S. 202, 59 L. Ed. 1272, 35 Sup. Ct. 795.

fair valuation. It was clearly proper to introduce evidence tending to show the intrinsic value of the shares. *Nelson v. First National Bank,* 69 Fed. 798, 803; *Critchfield v. Julia,* 147 Fed. 65, 73; *Henry v. N. A. Construction Co.,* 158 Fed. 79, 81; *Murray v. Stanton,* 99 Mass. 345; *IndustrialTrust Ltd. v. Tod,* 180 N. Y. 215, 232; *State v. Carpenter,* 51 Oh. St. 83; *Redding v. Godwin,* 44 Minn. 355; *Moffitt v. Hereford,* 132 Mo. 513.

The terms "value" and "market value" are also discussed in the following quotations:

Property concerning which no proof of value in the market can be given, because it is not brought into the course of trade and is incapable of any estimate in that mode, is often the subject of legal valuation. In such cases the value is to be ascertained from such elements of value as the property represents, among which may be the cost of producing an article. . . . . The question of value is not to be determined by considering the separate elements of which the property is composed, but by taking it as a whole, where it is, regard being had for the purpose for which it was intended and for which it is to be used.[47]

Where property is destroyed and injured which has a market value, this must be shown as the measure of damages; where it has no market value and a real value is shown, this is the measure of plaintiff's recovery; where it has neither a market value nor a real value, but it is shown what it would cost to replace or reproduce the article, then such cost is the measure of damages. But if the article has no market value nor real value, and it cannot be reproduced or replaced, then in that event it would be proper to show what it was worth to the plaintiff. . . . .[48]

. . . . Yet, a thing not bought and sold in the market may have a value, as when it is an article fitted for a specific use of the owners, and worthless for every other purpose. To attempt to test it by the open market, where it is never offered for sale, and is never bought, would be absurd. In reason the cost of replacing it would ordinarily be the standard of its value.[49]

Ordinarily, when an article of sale is in the market, and has a market value, there is no difference between its value and the market price, and the law adopts the latter as the proper evidence of its value. This is not, however, because value and price are really convertible terms, but only because they are ordinarily so in a fair

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[47] *Sutherland on Damages,* Fourth Edition, Volume 2, Article 448.
[48] *M. K. & T. Ry. Co. v. Crews,* 120 S. W. 1110, 54 Tex. Civ. App. 548.
[49] *Martinez v. State,* 16 Tex. App. 122, quoting 2 *Bish. Crim. Prac.,* sec. 751.

market. The primary meaning of value is worth, and this worth is made up of the useful or estimable qualities of the thing. . . .[50]

The value of land sought to be condemned, which the petitioner is required to pay, is not what any one person would give for the land for his own particular use, but what could probably be obtained for it if a sale was desirable and a purchaser sought, applying the ordinary business methods to find him and to dispose of the property.[51]

Valuation of patents.—The valuation of patents as at March 1, 1913, is fully discussed in Chapter XXIII.

Value of mines, oil wells, etc., March 1, 1913.[52]—The general principles underlying valuations as of a past date have been stated. In valuing mines, oil wells and other natural resources the Treasury requires many details. The burden of proof is properly put upon taxpayers to support their claims and any reasonable data required must be furnished or taxpayers may expect that claims will be disallowed. As the Treasury's requirements[53] are available to all who are interested it is not necessary to quote at length therefrom.

Computation of value of mines, etc., at March 1, 1913, or any other given date.—The following table is used by the Treasury's engineers in the valuation of mines, in those

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[50] *Kountz v. Kirkpatrick,* 72 Pa. St. 376, 13 Am. Rep. 687.

[51] *Weiser Valley Land & Water Co. v. Ryan,* 190 Fed. 417, 111 C. C. A. 221, (the quotation is from the syllabus to the case).

[52] For detailed regulations describing the present value method, see Chapter XXXVIII.

[53] The following forms may be obtained upon application to the Superintendent of Documents, Government Printing Office, Washington, D. C., for a nominal sum:

Form D Schedules for valuation, depletion and depreciation
E Schedule for valuation of coal properties
F Schedule for valuation of deposits of non-metals
O For oil and gas producers
P Royalty interests in metal mines
T General forest industries questionnaire for the years prior to 1919
T (Timber) Forest industries schedule

cases in which the valuation is based on the discounting of prospective earnings to present value. Following the table is an illustration showing the application of the formula.

Present Worth of Each Dollar of Operating Profit

Accumulated during life of *n* years, assuming annual rate of production and operating profits per unit to be uniform and providing for interest on present worth at *r'* per cent annually and a payment into a sinking fund which at 4 per cent, interest compounded annually, will amount to the present worth, i.e., provide for return of capital, at the end of life.

Yrs.	6%	7%	8%	9%	10%	12%	15%
1	.943396	.934579	.925925	.917431	.909090	.892857	.869565
2	.908766	.892946	.876891	.861777	.847176	.819408	.781010
3	.876389	.853937	.832607	.812317	.792993	.756976	.708694
4	.846052	.818370	.792418	.768072	.745178	.703254	.648525
5	.817570	.785469	.755780	.728260	.702675	.656540	.597680
6	.790781	.754961	.722245	.692177	.664641	.615547	.554148
7	.765540	.726638	.691435	.659519	.630410	.579284	.516457
8	.741717	.700174	.663032	.629635	.599440	.546979	.483507
9	.719198	.675487	.636765	.602251	.571286	.518017	.454455
10	.697880	.652354	.612404	.577066	.545581	.491906	.428649
11	.677672	.630699	.589748	.553820	.522019	.468244	.405574
12	.658489	.610277	.568624	.532281	.500344	.446702	.384818
13	.640258	.591066	.548887	.512330	.480337	.427009	.366049
14	.622911	.572950	.530401	.493737	.461815	.408936	.348995
15	.606385	.555828	.513053	.476390	.444619	.392292	.333431
16	.590625	.539630	.496741	.460167	.428610	.376914	.319170
17	.575581	.524283	.481376	.444963	.413671	.362663	.306056
18	.561205	.509716	.466880	.430685	.399699	.349420	.293955
19	.547455	.496371	.453178	.417253	.386603	.337082	.282754
20	.534292	.482719	.440211	.404592	.374302	.325559	.272358
21	.521680	.470171	.427920	.392637	.362729	.314774	.262682
22	.509587	.458216	.416255	.381334	.351818	.304658	.253654
23	.497979	.446805	.405166	.370630	.341517		
24	.486835	.435903	.394619	.360479	.331775		
25	.476122	.425477	.384571	.350840	.322549		
26	.465820	.415496	.374988	.341675	.313799		
27	.455905	.405935	.365839	.332951	.305488		
28	.446356	.396767	.357096	.324637	.297587		
29	.437155	.387970	.348734	.316704	.290063		
30	.428283	.379520	.340726	.309127	.282893		
31	.419724	.371399	.333054				
32	.411462	.363589	.325695				
33	.403483	.356072	.318631				
34	.395772	.348832	.311846				
35	.388318	.341856	.305324				
36	.381108	.335128	.299049				
37	.374130	.328637	.293009				
38	.367375	.322371	.287190				
39	.360832	.316318	.281581				
40	.354491	.310468	.276171				
41	.348345	.304811	.270950				
42	.342385	.299339	.265909				
43	.336602	.294043	.261038				
44	.330990	.288913	.256328				
45	.325540	.283945	.251774				
46	.320248	.279128	.247367				
47	.315107	.274459	.243100				
48	.310109	.269929	.238967				
49	.305250	.265533	.234962				
50	.300525	.261266	.231079				

Factors in Above Table

$$\frac{P_n}{n} = \frac{1}{\dfrac{nr}{R^n - 1} + nr'}$$

Derived from Hoskold's Formula

Present value of $1 per annum in *n* years, interest on capital being at one rate, *r'*, and for redemption another rate, *r*, per cent. $\Big\} = P_n$

$$P_n = \frac{1}{\dfrac{r}{R^n - 1} + r'} \quad \text{where } R^n = (1 + r)^n$$

Example

Copy of a memorandum prepared by the Metals Valuation Section of the Income Tax Bureau in determining the valuation of a mine at March 1, 1913. Italics are author's notes.

Ore reserves March 1, 1913	875,000 tons
Gross value March 1, 1913 (875,000 × $12.78)	$11,182,500
Selling price of metal in ore reserves—actual or anticipated.	
Gross cost March 1, 1913 (875,000 × $7.1537)	6,259,487
Cost of mining and extracting metal in ore reserves—actual or anticipated and exclusive of depletion and of depreciation of plant.	
Art. 206 *of Reg.* 62, *defines such "cost" as comprising all current expenses of producing, preparing and marketing the mineral product sold, exclusive of federal income and profits taxes, allowable capital additions as defined in Art.* 222 *of Reg.* 62, *and deductions for depreciation and depletion, but including cost of repairs and replacements necessary to maintain the plant and equipment at its rated capacity and efficiency.*	
Net returns (*actual or anticipated*)	$4,923,013
Present worth (discounting at 15% and 4%, using 8-year life).	
Present worth is inclusive of cost of plant and is based on earnings on capital or purchase price at the rate of 15% *per annum and making payments into a sinking fund which at* 4% *compounded annually will provide for the return of capital at end of* 8*-year life.*	
The above table is calculated for the investment of a sinking fund at 4%, *the variables being the rate of discount on capital and the years of life. From the table we find that the present value of each dollar of operating profit accumulated during the life is* .483507.	
Present worth therefore is $4,923,013 × .483507 =	$2,380,311
Deduct cost of plant (*actual or prospective*)	1,000,000
The Treasury deducts the full cost (actual or prospective) of the plant from the March 1, 1913, *present value of the mine on the assumption that the plant must be constructed and the full investment therefor made at the beginning of the period during which the ore is to be removed. If the plant had been constructed prior to March* 1, 1913, *its value at that date would be deducted.*	
Market value of ore *en bloc* March 1, 1913	$1,380,311
Unit of depletion per ton ($1,380,311 ÷ 875,000 tons)	$1.5775

"Discovery" value of mines, oil and gas wells.—

Ruling. In computing the gain or loss from the sale of mines, oil and gas wells, discovered on or after March 1, 1913, the tax-

payer is not entitled to set up the value as of date of the discovery or within thirty days thereafter, as the basis of the computation. . . . . (C. B. 3, page 44; Sol. Op. 26.)

Such value is permitted, however, for depletion purposes. (See Chapter XXXVIII.)

Value of claims for infringements, judgments, etc., March 1, 1913.—The rules for determining the values of intangible assets at March 1, 1913, are in many respects similar to those heretofore discussed. The position of the Treasury is set forth in a ruling in the case of a taxpayer who had secured a perpetual injunction in 1911, restraining an infringer of its patents.

RULING. Thus, on this date (July 31, 1911) a definite, assignable property right vested in the M Company.

The case was referred to a master of the court to ascertain and determine subject to the approval of the court the amount of said gains, profits and damages. The master filed a final report with the court on April 18, 1918, measuring the damages to be the loss or profit on the sales lost by the complainant. . . . .

In the latter part of 1918 the case was compromised, and the amount finally agreed upon and received was X Dollars. . . . .

In view of the foregoing it is held that the amount received in 1918 does not constitute taxable income for that year, for the reason that the right to receive this amount existed and was a part of the assets of the M Company on March 1, 1913. (Unreported to date.)

Value of goodwill at March 1, 1913.—The Treasury has suggested the following methods of arriving at the value of goodwill:

1. The difference between the price at which an article is sold under the trade-name and under no trade-name multiplied by the number of units sold during the year equals profits attributable to goodwill. Capitalize such annual profit on a 20 per cent basis.

2. Comparison with businesses having similar sales and profits when such companies have goodwill purchased for cash.

3. Ruling. . . . . The third method and possibly the one which will most frequently have to be applied as a check in the absence of data necessary for the application of the preceding ones, is to allow out of average earnings over a period of years prior to March 1, 1913, preferably not less than five years, a return of 10 per cent upon the average tangible assets for the period. The surplus earnings will then be the average amount available for return upon the value of the intangible assets, and it is the opinion of the committee that this return should be capitalized upon the basis of not more than five years' purchase—that is to say, five times the amount available as return from intangibles should be the value of the intangibles. . . . . (C. B. 2, page 31; A. R. M. 34.)

Later[54] the Treasury held that the 10 per cent was to be applied to the *net* tangible assets. Of course, the smaller the average *net* tangible assets to be capitalized, the greater will be the earnings remaining to be capitalized at 20 per cent to establish the goodwill value.

In businesses that are more or less stable, the Treasury suggests 8 or 9 per cent return on tangibles and capitalizes the earnings applicable to goodwill at 15 per cent.

Earnings of predecessor organization may be used.—

Ruling. In determining the value of good will as of March 1, 1913, in accordance with the third method outlined in A. R. M. 34 (C. B. 2, p. 31), and as a factor in the ascertainment of the value of a share of stock as of that date, a corporation which had not been in existence for a period of five years prior to that date was permitted to take the average earnings of the business for five years, thus including a part of the period of the partnership organization that preceded incorporation. (C. B. 5, page 54; Digest O. D. 1146.)

It would also be proper to use the earnings of a predecessor corporation. In reorganizations, consideration must be given to any abnormal conditions that may have affected adversely the earnings of the predecessor, such as change in product, need for reducing fixed charges, expansion of facilities, all of which may have prevented the former organization from showing large earnings, even though possessing a valuable goodwill on which the successor corporation was able to realize excellent profits in subsequent years.

[54] C. B. 3, page 43; A. R. M. 68.

Deduction for federal taxes—ascertainment of net earnings.—The ruling quoted below is of particular interest, not only in holding that federal taxes need not be deducted in arriving at net earnings for purposes of goodwill valuation, but because it clearly permits the taxpayer to consider only those ordinary expenses and costs which a prospective purchaser would take into account. Any extraordinary expenditures should be restored to income for the purpose of the computation.

A failure to cover sales commitments in a rising market resulted in a loss to one concern which had a very valuable goodwill and sold it for cash the following year at a high figure. The loss in question materially reduced its average earnings for the preceding five years. Such abnormal conditions require that the earnings record be studied with care. What is necessary is that a value shall be reached, after full consideration of all the factors, that would influence an intelligent purchaser, who would make due allowance for fluctuations in profits, trend of sales, excess plant capacity (if any), management, character of product, etc.

Ruling. . . . . Following the application of A. R. M. 34 employed in A. R. R. 252, the Unit, in the instant case, has determined the value of the intangible assets thus:

On November —, 1919, A sold the business of which he was sole owner. It was necessary to report as income the difference between the value of the business on March 1, 1913, and the price at which it was sold. An appraisal of the tangible assets was made at or about the time of the sale. Five years' earnings prior to the date of sale—that is, earnings for 1915 to 1919, inclusive—have been averaged and a rate of 8 per cent on the value of the tangible assets determined by the appraisal has been considered a fair return on such tangible assets and the balance divided by the difference between the selling price of the business and the appraised value of the tangible assets, which gives a percentage of 11.33 as the return on the good will. This ratio of 11.33 applied to the average earnings for five years prior to 1913 gave the value of the good will, etc., as of March 1, 1913. . . . .

The real consideration presented by the inquiry of the Income Tax Unit, therefore, appears to be whether the war and excess profits taxes imposed upon the business of an individual by section 201 of the Revenue Act of 1917 should be deducted in determining the

earnings for the year 1917 of the intangible assets employed in such business.

The value of the intangible assets to be determined, as above pointed out, is the value as of March 1, 1913. At that time no tax was imposed upon the business of an individual as such, nor was any in contemplation. Any tax not imposed until nearly four years later certainly was too remote to have been anticipated. Such a tax, therefore, could not have entered into the consideration of any prospective purchaser of a business in determining upon its worth to him. In determining, therefore, the rate per cent to be applied in capitalizing the net earnings as of March 1, 1913, it is believed that no other or different factors should enter into the equation than those which would have been used by a prospective seller and a prospective purchaser as of that date, even if it be conceded, for the sake of argument, that such taxes constitute expenses which would properly be deductible in determining the net earnings of intangible assets for the purpose of computing their value as of a later date. But the tax imposed by section 201 of the Revenue Act of 1917 is "a tax * * * equal to the following percentages of the net income." It seems reasonably clear, therefore, that the tax does not apply until all permissible deductions from earnings have been made and that the tax does not itself constitute a deduction in determining such earnings.

It is therefore held, in the case of A, that in determining the earnings chargeable to good will in accordance with A. R. M. 34 Federal income taxes are not to be deducted. (C. B. I-1, page 24; A. R. M. 145.)

The use of the average rate of earnings on intangible value during 1915-1919 as the basis for capitalizing actual earnings assignable to intangibles prior to 1913, is open to question. Rates of earnings and interest were both abnormally high during a considerable portion of the period of 1915-1919, and this was presumably taken into account by the purchaser of the property in 1919. He would certainly expect to capitalize abnormal earnings at a higher rate of return than earnings during a period of relative business depression such as some of the years preceding 1913.

When the earnings of the years immediately prior to March 1, 1913, were low, due to any abnormal condition, and the earnings of the years immediately following March 1, 1913, reflect a more normal situation, the capitalization of the earnings after March 1, 1913, is permissible.

It is admitted that great difficulty arises in determining the goodwill of a business which did not change hands at or about March 1, 1913. Less difficulty arises in the case of a corporation if a considerable number of the shares of its capital stock was sold at or about March 1, 1913. The following ruling is sound:

RULING. In determining the value of a corporation's assets, including good will, as at March 1, 1913, contemporary sales of stock are held to be of greater weight than values based on appraisal. (C. B. 1, page 73; O. 791.)

The foregoing ruling, however, cannot be applied if only a few shares were sold.

RULING. In applying the third method outlined in A. R. M. 34 (C. B. 2, p. 31), of determining value as of March 1, 1913, of intangible assets, individuals or partnerships in determining net earnings should deduct a reasonable amount on account of the salaries of owners actively engaged in the business. (C. B. 4, page 43; O. D. 937.)

GOODWILL IN RELATION TO FEDERAL TAXATION.—The following discussion[55] calls attention to some of the most important points which one should consider when placing a value upon goodwill:

Goodwill is an intangible and fluctuating asset which represents the value of a business over and above the money, other tangibles and accumulated profits invested in it. . . . .

In actual sales and purchases the value has been computed in a variety of ways, among which are: (1) the aggregate of the entire earnings of a specified period; (2) a certain number (of years' purchase) times the average earnings in excess of a determined rate on the average tangible investment for several years; and (3) the capitalization of an average of several years' earnings at a specified rate, deducting therefrom the value of the tangible assets. It is undoubtedly true that in a number of cases the amount paid for goodwill represents only the difference between the book value and the sales price, which price is the result of a compromise between bid and asked prices with little or no regard to any of the above-mentioned methods of computation.

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[55] *Goodwill in Relation to Federal Taxation,* by N. J. Lenhart, Chicago office, Lybrand, Ross Bros. and Montgomery.

Goodwill has a value as a rule only when a business has earned and it is expected will continue to earn a rate on the invested value of the tangible assets in excess of a certain basic rate of return. The exception to the rule would be, for example, when a large amount of advertising has been done but sufficient time has not elapsed to show the value of this advertising. The excess of earnings arises from a number of factors, such as patents, reputation for integrity, trade-names, publicity from past advertising, location and a partial or complete monopoly. . . . .

In general, investors in bonds, preferred stocks or common stock place considerable importance on the past earnings, reputation and the factors of goodwill (although perhaps not to the same degree), because no investor is willing to invest in a business which he does not believe is reasonably assured of continued success.

The rate of return (earnings to investment) that will attract investments in common stock in any particular industry cannot be reduced to a definite figure. The factors which affect the yield expected are:

1. A seasoned stock with a long-continued earning and dividend record sells at a lower yield than an unseasoned stock.
2. A business with stable earnings sells at a lower yield than a business in the same industry with unstable earnings.
3. A steady growth in earnings always attracts investors at a lower yield than an unsteady growth or no growth.
4. The liberality of the dividend distribution, marketability and sectional money rates have considerable effect on the yield expected.

It, therefore, seems reasonable to assume that there is no general rate of return necessary to attract investors in any particular industry.

If any particular business is in question and a rate of return which will attract an investor is agreed upon, the question arises as to whether the investor desires the agreed return upon his whole investment or if he desires the agreed rate on his investment in tangible assets and a higher rate on the amount invested in goodwill.

One method of computation which has been often used is to decide on the rate of earnings necessary to attract the investor, which may be 9 per cent, for example, and then to take, say, five times the excess of earnings over the 9 per cent on the investment during a specified period. Under this method the resulting rate of earnings on the new investment figure is always larger than the rate represented by 9 per cent, provided, as is nearly always the case, that the number of years used is less than 100 divided by the rate used, and so it might be concluded that the investor requires a higher rate

of return on the amount invested in goodwill than on the balance of his investment.

That this is not generally the case is shown by:

1. In many instances a business is purchased in which goodwill is the bulk of the asset bought. This is particularly true when the goodwill consists largely of patents, or in the case of retail stores where the location is particularly favorable.

2. The purchaser expects to continue the business and further develop the goodwill. The various elements of goodwill, such as location, patents and trade-names, are no more likely to depreciate than are the physical assets through misuse, obsolescence and poor management.

3. The Treasury Department has consistently refused to allow depreciation on goodwill purchased, which attitude assumes goodwill to be of a more permanent nature than the physical assets.

It is consequently reasonable to assume that a rate of return which will attract the investor is a rate on his entire investment including goodwill.

In view of the foregoing discussion there are two methods of goodwill computation at March 1, 1913, which seem desirable in two situations, namely: (1) when the business is sold and a price paid for the goodwill, and (2) in case there has been no sale and when the value at which goodwill is paid in for stock is to be determined or in the case of liquor interests in which the goodwill has been lost through enactments by Congress.

The procedure to be used in the first instance can best be shown by an illustration of an actual case. The facts are as follows:

Income in 1910	$150,000.00	Investment for 1910	$750,000.00
Income in 1911	160,000.00	Investment for 1911	800,000.00
Income in 1912	170,000.00	Investment for 1912	850,000.00
Total	$480,000.00		$2,400,000.00
Average	$160,000.00		$ 800,000.00

Per cent of return 20%

Income in 1917	$425,000.00	Investment for 1917	$2,000,000.00
Income in 1918	375,000.00	Investment for 1918	2,400,000.00
Income in 1919	322,000.00	Investment for 1919	2,800,000.00
Total	$1,122,000.00		$7,200,000.00
Average	$ 374,000.00		$2,400,000.00

Per cent of return 15.5%

In this case the amount actually paid for the goodwill early in 1920 was $1,000,000, which, added to the average investment of

$2,400,000 gives a new average of $3,400,000. The earnings for 1917, 1918 and 1919 were 11 per cent on the $3,400,000, and it is quite evident that the investor expects to get not more than 11 per cent without further development of the business.

Now the earnings decreased during the period of 1917, 1918 and 1919, but increased in the pre-war years. Conditions were stable in 1910, 1911, 1912, whereas the years 1917, 1918 and 1919 were war-time years and a period of depression could be expected. Since when conditions are stable and the earnings show a steady increase, the risk is considered less and the expected yield is lower than when the reverse is true, it follows that in 1913 an investor or the same investor would undoubtedly have been satisfied with considerably less than 11 per cent and certainly not more than 10 per cent. On the basis of $160,000 average earnings in the pre-war years and an expected return of 10 per cent, the business was worth at least $1,600,000 at March 1, 1913, and the goodwill then was worth $800,000. Due to the nature of the business, patents, location, reputation, etc., the earnings could be expected to continue for a minimum of seven years and probably longer without additional development. Seven times the average earnings over 10 per cent in the pre-war years shows a goodwill of $560,000, which is obviously low (this is demonstrated in the actual case just cited), and this method admits of more argument than the one used in the illustration. In case there are factors which make the pre-war period entirely different from the years preceding the date of sale, this method based on the actual sales price as illustrated above may be open to criticism, but as a rule it seems to be the fairest and least open to attack in case there has been an actual sale of goodwill.

In case there has been no sale of the goodwill a more or less arbitrary method must be adopted. Any method used will be open to discussion and it is of the highest importance to get as many comparatively definite factors as possible.

It has been demonstrated in the published Treasury Department's reports that in the pre-war years the great majority of industries earned less than 10 per cent upon the invested capital. It follows, therefore, that in most industries the rate which could be expected by the investor willing to pay an amount equal to or greater than the invested value of the tangible assets was less than 10 per cent. The variations in the rates expected by an investor between industries as a whole depend upon the risk involved. This risk varies directly with the number of years the profits of the industry can be expected to continue according to the character of the business.

The preferred stock rate expected in an industry varies much less between the various businesses in the industry than does the rate on common stocks; and the preferred stock rate is, therefore, much easier to obtain and less open to question.

If the expected rate of return on the investment in a business were known it would be easy to capitalize the average earnings at that rate and call the difference between the book value of the net tangible assets and the figure so found goodwill. But this rate is unknown and certainly could never be satisfactorily agreed upon. However, since the expected rate varies directly with the risk, the rate would seem to be about the rate of the average earnings to an investment figure made up of the book value plus a number of years times the average excess of earnings over the preferred stock rate. The number of years will be determined according to the risk.

The manner in which this method is used is as follows:

Income in 1910	$150,000.00	Investment for 1910	$750,000.00
Income in 1911	160,000.00	Investment for 1911	800,000.00
Income in 1912	170,000.00	Investment for 1912	850,000.00
Total	$480,000.00		$2,400,000.00
Average	$160,000.00		$800,000.00

Preferred stock rate was about 6% during 1912:

6% on average investment	$ 48,000.00
Average earnings	160,000.00
Excess over 6%	$112,000.00
Seven times excess over 6%	$784,000.00

The goodwill, as computed above, amounts to $784,000 as compared with $800,000 under the method previously discussed.

The preferred stock rate should be the rate in the industry in the locality of the particular business. This rate can be found with some degree of accuracy, and at least with a much greater degree of accuracy than the rate necessary to attract investors to the purchase of common stock. The rate should be the average over a period of not more than a few years prior to the date at which goodwill is to be computed.

If a standard line of industry is decided upon and the number of years' purchase to be used in that industry is agreed upon, the relative degree of risk and the number of years to be used in some other industry should result in no wide divergence of opinion. The number of years to be used in finding the average return on the investment need not be the same as the number of years' purchase used, since cognizance must be taken of any special features present and facts which make certain years abnormal.

The conclusion to be drawn from the foregoing discussion is that a set formula cannot be developed for the computation of goodwill, but each case should be considered on its merits. If there has

been a sale of the goodwill the first-mentioned illustration or an adaptation of it would give the most accurate result.

If there has been no sale some variation of the second illustration should be issued.

The following extract from *The New York Times* of November 3, 1922, arising from the valuation of the estate of the late Temple Bowdoin, of J. P. Morgan and Company, is of interest:

Transfer Tax Appraiser Berwin, in estimating the value of the good-will interest, accepted the average annual profits for ten years, and multiplied this sum by three. This is called the "purchase value," and is explained by George Brokaw Compton in a treatise on good-will as follows:

"This multiple, or a number of times the average annual net profit, is held to equal the amount a purchaser would be willing to pay solely for the advantage of continuing the business."

Appraiser Berwin accepted "three years purchase" as the value of Mr. Bowdoin's interest in the good-will over the protest of Lafayette B. Gleason, counsel for the State Tax Commission, on the ground that the appraiser should have fixed the "purchase" at a higher multiple than three. In appraising an interest in the business of Franklin Simon & Co., the multiple of five was fixed by the Surrogate, while the good-will value of stock in Tiffany & Co. was estimated on a basis of ten years purchase. Stock in the Hearn department store was appraised on a multiple of five. It is expected that an application will be made in the Surrogate Court to increase the value of the good-will on the ground that a higher multiple than three should have been used, and that the basis for the good-will fixed at the present time will be used in later taxation of estates of other members of the Morgan firm.

In valuing shares of stock as at March 1, 1913, when there was no market value determinable, the Treasury applied a formula for fixing the value of goodwill:

Ruling. . . . . The Committee is of the opinion that the market value of shares of stock was what they would bring, and that the best evidence of what they would bring is what such shares did in fact bring when offered for sale about that time in a free and open market. However, in the present instance, it is understood that there were no sales, and it is necessary to apply other tests, the market value in such case being deemed to be what a willing buyer might reasonably have been expected to pay or a willing seller to accept for the stock. . . . . A prudent investor contemplating an investment,

usually takes into consideration primarily two factors; first, the safety of his capital, and second, the return on it which he may reasonably expect. . . . . (C. B. 3, page 46; A. R. R. 252.)

The formula set forth in the foregoing ruling is summarized below, using the figures given in the ruling:

1916

Tangible assets	$610x$
Selling price of entire common stock	$1,200x$
Received for good will	$590x$

Average tangible assets ($3\frac{1}{3}$ years prior to sale)	$586x$
Average net income (same period)	$112x$
8% of $586x$ = (approx.)	$46x$
Balance applicable to good-will	$66x$

Percentage $66x$ to $590x$ = 11% (approx.) = percentage to be used in capitalizing average earnings at March 1, 1913, applicable to good-will.

1913

Average tangibles (5 years prior to March 1, 1913)	$258x$
Average earnings	$30x$
8% of $258x$ = (approx.)	$20x$
Earnings attributable to goodwill	$10x$
Capitalizing $10x$ at 11.13% = (approx.)	$92x$ = value of goodwill March 1, 1913.
Add, book value of tangibles at March, 1913	$232x$
Value of total assets, March 1, 1913	$324x$
Deduct, par value of preferred stock	$50x$
Value of common stock, March 1, 1913	$274x$

Adjustment of appraisals of various dates.—Most appraisals made either by taxpayers or disinterested third parties are of some date other than March 1, 1913. If made within a short time before or after that date the books of account should afford sufficient data upon which adjustments could be based. When the date of the appraisals is more than a year before or after March 1, 1913, the application of book

adjustments is not of itself evidence that the result would represent fair market value as of that date. Actual conditions at the date of the appraisals would have to be compared with conditions existing March 1, 1913. If it could be shown that building materials, labor and other elements of cost were substantially the same, and if normal depreciation were applied, there is no good reason why an appraisal of a date more than a year before or after should not form the foundation for an adjustment of book figures to conform to fair market value at March 1, 1913. The Treasury in a ruling published early in 1922 (C. B. I-1, page 353; A. R. R. 747)[56] has held that "retrospective" appraisals will be accepted "when the facts upon which the appraisals are based have been established by proof." The proof need be only such "as is ordinarily accepted in important business transactions of like character." The acceptance of such appraisals is an important departure from the Treasury's previous procedure. The purpose for which an appraisal was made should always be stated, since it may be the controlling factor in its acceptance or rejection.

When the actual surplus at March 1, 1913, does not appear on the books of the individual, firm or corporation, the difficulty of the case is apparent, but the mere absence of definite recorded figures compiled and stated on that exact date does not preclude a legitimate inquiry at a later time and an endeavor to ascertain accurate data as of that date.[57] Much of the work of public accountants consists in stating accounts as of a past date, and their findings are almost invariably sustained by the courts. Therefore, if a corporation, say, in 1917, sets up in its books certain assets acquired before March

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[56] For full text of ruling, see *Income Tax Procedure*, 1922, pages 1589-1597.

[57] *Doyle v. Mitchell Brothers Company*, 247 U. S. 179, 38 Sup. Ct. 467, 62 L. Ed. 1054 (May 20, 1918). Case decided under the 1909 law: "Nor is the result altered by the mere fact that the increment of value had not been entered upon plaintiff's books of account. Such books are no more than evidential, being neither indispensable nor conclusive. The decision must rest upon the actual facts."

1, 1913 (but not carried on its books at any valuation, or at a low valuation), credits surplus and declares a large special dividend, it cannot be contended that there is there a distribution of *taxable* income, unless the undistributed earnings accumulated since March 1, 1913, are sufficient to cover the payment.

Comparative values of similar property.—

RULING. In general, value as at March 1, 1913, of property, real, personal, or mixed, may be established by consideration of bona fide transactions in like property occurring on or about March 1, 1913, together with all other facts pertaining to such value. (C. B. 1, page 37; O. D. 7.)

Prorating land and crop values.—

RULING. A purchased for a certain price land together with crops growing thereon. The basis for determining gain or loss upon subsequent sale of the crops is the difference between the cost, or if no part of the purchase price was assigned to the crops, the fair market value thereof at the time of purchase, and the selling price less cost of harvesting and marketing. (C. B. 3, page 49; O. D. 714.)

Average of stock quotations on March 1, 1913.—The question has arisen as to which price shall be accepted in the case of stock listed on an exchange, which was sold at varying prices on March 1, 1913. A ruling has been issued covering this point as follows:

RULING. "The fair market price or value of March 1" is held to be the fair market price or value as of the entire day of March 1, which, in the case of variation between "opening and closing price" for the day, would mean the average price for the day. This, however, would be conditioned upon showing that the *exchange quotation* represented the fair market price or value of the stock, as it is this "fair market price or value" which is to control, however that fact may be ascertained. (Letter to the Corporation Trust Company, signed by Commissioner W. H. Osborn, and dated November 21, 1916.)

In view of frequent references to the March 1, 1913, date it is worth while to note that in legal and commercial usage this refers to facts as they existed at the commencement of

business on March 1, 1913. In the regulations the date January 1, 1909, is often used. In commenting thereon the Supreme Court of the United States has said "December 31, 1908, would have been more precise,"[58] meaning that as the date from which to measure changes in values, December 31, 1908, should have been selected instead of January 1, 1909. It may safely be assumed that if called upon to pass upon a case where there was a difference between prices at the close of business February 28, 1913, and the average of prices during the entire day of March 1, 1913, the Supreme Court would doubtless uphold the closing prices of February 28, 1913.

New York Stock Exchange prices on March 1, 1913, were substantially the same as on February 28, 1913, so the point is probably of little importance.

Ruling. The value of shares of stock as at March 1, 1913, should be determined on the basis of market quotations as at that date instead of book values. (C. B. 2, page 30; Digest A. R. R. 33.)

When only a few shares were sold before and after March 1, 1913, taxpayers may claim that such sales were not representative nor controlling. The Treasury itself supports the statement.[59]

Valuation of closely-held stocks.—

Decision. In appraising shares of stock held in a corporation whose sole property was an office building, the shares having always been held in one family and never sold, the contention of the executors was that the value of the shares should be determined by the earnings of the property, which were shown to have been from 2.18½ to 4.15½ per cent over a period of six years. The value was claimed not to exceed $50 per share and the federal authorities had valued it at $39 per share. [The par was $100.]

The court held that capital stock representing a building in good condition must be considered as worth the amount originally contributed by the shareholders; that the stock represented the assets, suggesting this to be the foundation of the stock dividend decision

[58] *Hays v. Gauley Mountain Coal Co.*, 247 U. S. 189, 38 Sup. Ct. 470, 62 L. Ed. 1061, May 20, 1918.

[59] See Art. 1561.

(*Eisner v. Macomber*); that while earning power was of very considerable influence upon market value, it was but one of the elements and not the most important one; that the argument advanced would lead to the conclusion that where a corporation had been running at a loss, the stock would be worthless.

The fact that the stock in question represented a minority interest was held not material under the circumstances where the corporation owed no debts and where its property consisted of a large office building, well located in the heart of a growing city and where there had been no dissension among the stockholders. The shares were held worth par, one judge dissenting.[60]

Value fixed by appraisers of state court may be rebutted.—

Ruling. The appraised value of stock as at the time of the creation of a trust estate, by appraisers of a State court, creates a presumption only that the stock is of the appraised value; this presumption may be rebutted by competent evidence to the effect that the stock was of another value than that appraised. (C. B. 1, page 38; Digest A. R. M. 7.)

In one case the executrix was the residuary legatee. There was no direct inheritance tax in the state at that time; no question of commissions was involved; the real value of the stock did not seem to be a vital one to the appraisers, who in 1914 valued stock at $100 a share. The real value was over $500 a share. The Treasury allowed a reappraisal in this case because the value of $100 a share was merely nominal.

Pro rata method—how far valid.—The early regulations under both the 1909 and the 1913 laws[61] laid down the rule that in the case of certain appreciations in values extending through a period which began before the effective date of the law, the appreciations should be considered to have accrued evenly throughout the period. The taxable portion, consequently, should be determined by a prorating process which would make the amount taxable depend upon the relative length of the period elapsed before and after the act took effect. The Supreme Court has made it plain that this method,

[60] Note on *Succession of Coleman*, 85 Southern 43 (La.) appearing in the *Bulletin of the National Tax Association*, Vol. VI, page 57.

[61] 1909 law, Reg. 31, 1909; 1913 law, T. D. 2291, February 8, 1916.

while in itself not illegal as a method, must be considered merely one way of ascertaining the value of the property at March 1, 1913. In certain cases it may be the best or the only way of estimating that value and in such cases the court has indicated its acceptability. In the presence of some less arbitrary and more accurate method of valuing property at the effective date of the law, the *pro rata* method is not to be considered valid.

In a case under the 1909 law, *Hays v. Gauley Mountain Coal Company* (decided by the Supreme Court of the United States, May 20, 1918),[62] the court pointed out the necessity of establishing the value of the capital assets on December 31, 1908, and commented as follows on methods of determining that valuation:

Decision. Whether this should be done by taking an inventory upon the basis of market values then existing, or whether the entire increment accruing between the time of acquiring and the time of disposing of the assets should be prorated as if it had arisen through a series of gradual and imperceptible augmentations, is a matter of detail, to be settled according to the best evidence obtainable, and in accordance with valid departmental regulations. Treasury Regulations No. 31, December 3, 1909, provided for inventories at the beginning and end of each year with respect to manufacturing and mercantile companies; and with regard to a sale of capital assets acquired prior to January 1, 1909, and sold thereafter, required that the amount of increment or depreciation representing the difference between the selling and buying prices should be adjusted so as fairly to determine the proportion of the loss or gain arising subsequent to the date mentioned, but without prescribing any particular method of doing this. Subsequent rulings required that sales of stocks and bonds should be regarded as sales of capital assets and accounted for accordingly under Regulations No. 31, and, while still requiring inventories, resorted to the prorating method with respect to real estate, apparently on the ground that increases and decreases in the value of this class of property during particular periods could not be accurately determined. . . . .

The present case was heard upon an agreed statement of facts which contains nothing from which the value of the stock at the time the act took effect may be deduced, otherwise than by the prorating method that was adopted; nor is any objection made by the

[62] 247 U. S. 189, 38 Sup. Ct. 470, 62 L. Ed. 1061.

respondent to the application of that method. Hence there is no lawful ground for overthrowing the tax.

Again, in the case of *U. S. v. C. C. C. & St. L. Railway Co.*,[63] decided by the same court on the same day, the court remarked:

DECISION. Just how this part (the portion taxable because accrued after the effective date of the law) is to be separated from that which previously accrued is a matter of some nicety, as we have shown in the *Hays Case*, the Circuit Court of Appeals adopted the theory of an inventory taken as of the time the act went into effect; and although the assets here under consideration were not acquired for the purpose of sale in the manner of merchandise, but were bought for investment, and hence were not inventoried on December 31, 1908, it accepted the stipulated fact that the stock had a regular market value of $57 per share on that date as supplying the lack of an inventory. This result accords with the views we have expressed in the cases referred to.

The Treasury has pointed out that the *Gauley Mountain Coal Company* case merely approved the prorating method when there is no better way of determining fair "value."

In the year 1900 a taxpayer purchased two shares of corporate stock for an aggregate amount of 52 x dollars, and in 1915 sold the same shares for 36 x dollars. On March 1, 1913, this stock was quoted at 24 x dollars. The taxpayer claims that he is entitled to a deduction for loss upon the sale of stock to the extent of the pro rata part of the reduction from cost to sale price attributable to the period after March 1, 1913.

The excess of the proceeds of a sale in the year 1915 of stock acquired by the taxpayer prior to March 1, 1913, over the market value of such stock on March 1, 1913, determined according to "the best evidence obtainable," is income for such taxpayer for the year 1915, regardless of the fact that the sale price of such stock was less than the cost of such stock to the taxpayer. (C. B. 1, page 35; T. B. M. 73.)

In this case the Treasury held that the value of the stock

[63] 247 U. S. 195, 38 Sup. Ct. 472, 62 L. Ed. 1064.

on March 1, 1913, was "fairly shown by the market quotations on that date," which was a better measure than prorating, and therefore must be used. In view, however, of the Supreme Court decision in *Goodrich v. Edwards* (255 U. S. 527, 41 Sup. Ct. 390, 65 L. Ed. 758), there is no taxable gain in this case as original cost exceeded the selling price. Under the 1921 law, also, there would be neither taxable gain nor deductible loss in this case.

Income Derived from Sale or Exchange of Property Acquired by Gift and Inheritance

A new provision appeared in the 1921 law whereby appreciation of gifts in the hands of the donor is taxable to the donee when the latter subsequently disposes of the gifts.

LAW. Section 202. (a) . . . . (2) In the case of such property, acquired by gift after December 31, 1920, the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner. In the case of such property acquired by gift on or before December 31, 1920, the basis for ascertaining gain or loss from a sale or other disposition thereof shall be the fair market price or value of such property at the time of such acquisition; . . . .

Gifts after December 31, 1920.—

REGULATION. In computing the gain or loss from the sale or other disposition of property acquired by gift subsequent to December 31, 1920, the basis shall be the same as it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. This basis in the hands of the donor or last preceding owner by whom it was not acquired by gift shall be determined under the provisions of article 1561 and the taxable gain or deductible loss from the sale or exchange shall be computed in accordance therewith.

If the donee is unable to ascertain the facts necessary to determine such basis, he shall so state upon his return, and the Commissioner shall if possible obtain such facts from such donor or last preceding owner or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the value of such property as found by the Commissioner as of the date or approximate date such property was acquired by said donor or last preceding owner. In order to insure a fair and adequate appraisal or determination of the proper basis, donors making gifts of property on or after January 1, 1921, should leave an accessible record of the facts necessary to determine the cost of such property (and its fair market value as of March 1, 1913, where pertinent). (Art. 1562.)

Gifts before January 1, 1921, and bequests, devises or inheritances.—

Regulation. In computing the gain or loss from the sale or other disposition of property acquired by gift on or before December 31, 1920, or by bequest, devise, or inheritance, the basis shall be the fair market price or value of such property at the time of acquisition. The term "property acquired by bequest, devise, or inheritance" as used herein includes (*a*) such property interests as the taxpayer has received as the result of a transfer, or creation of a trust, in contemplation of or intended to take effect in possession or enjoyment at or after death and, (*b*) such property interests as the taxpayer has received as the result of the exercise by a person of a general power of appointment (1) by will, or (2) by deed executed in contemplation of or intended to take effect in possession or enjoyment at or after his death. . . . In the case of property acquired by gift, bequest, devise, or inheritance, prior to March 1, 1913, the taxable gain or deductible loss from the sale or other disposition thereof shall be computed in accordance with article 1561. In the case of property acquired by bequest, devise, or inheritance, its value as appraised for the purpose of the Federal estate tax or in the case of estates not subject to that tax its value as appraised in the State court for the purpose of State inheritance taxes shall be deemed to be its fair market value when acquired. (Art. 1563.)

The accepted principle of law is that property acquired from donors or decedents is capital in the hands of the recipients, and that under the sixteenth amendment to the Federal Constitution no income tax can be imposed thereon. This principle was adopted in the 1913, 1916, 1917 and 1918 fed-

eral income tax laws. As to property acquired from decedents, the rule is followed in the 1921 law.

No income tax is imposed upon an estate for any appreciation in values which may exist at the date of death, but inheritance taxes are based on actual values.

As to gifts other than from decedents, an attempt is made in the 1921 law to tax appreciation in the value of gifts made after December 31, 1920, when, as and if realized by donees.

Income from sale of property acquired by gift.[64]—Early in 1921, the House of Representatives passed an act[65] amending the existing law and ascribing to donees upon realization the same measure of gain as would have been realized by donors if the gift had not been made. The Act did not pass the Senate.

The act was meritorious so far as it reached palpable evasion of taxes upon actual profits. Taxpayers owned property which had increased tremendously in value since 1913. The taxpayers having received very favorable cash offers for their properties and being unwilling to pay any tax on the prospective profit, conveyed the property to their wives. Immediately after the conveyance the wives would sell the properties and under the 1918 and prior laws no tax could be assessed thereon. It was agreed that something should be done to reach this species of evasion.

Prior to January 1, 1921, if the recipient of a gift disposed of it during his lifetime, he reported as taxable income (if a profit was realized) the difference between the value of the gift the day it was received, or if it was received before March 1, 1913, its value on that date, and the amount realized. If the proceeds of the sale were less than the value on the date of receipt of the gift or on March 1, 1913, the resulting loss was an allowable deduction.

The state of New York attempted to tax donors at the

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[64] Section 202 (a-2).
[65] H. R. 14198, passed House of Representatives May 27, 1921.

time of making gifts,[66] on the gain measured by the difference between the cost to the donor and the value of the gift when made. The Appellate Division of the Supreme Court of the State of New York held the regulations of the Comptroller to be invalid on the ground that no taxable income was realized.[67]

The 1921 law[68] does not fall into the error of taxing the gift itself. The tax is imposed only upon actual realization by the donee of a gain measured by cost to the donor. As a means of reaching gains which should properly be taxed, the new provision is meritorious. A limit of time, however, should have been fixed. Palpable evasions of tax usually arose when sales were made immediately after transfers of property. In other words, the sales, in effect, were transactions by and for the ostensible donors. The gifts were not *bona fide*. When sufficient time elapses between the date of a gift and realization by donees, it may be assumed that the gift is *bona fide*.

Undoubtedly the legality of the new provision will be attacked. Donees in receipt of *bona fide* gifts cannot be held to realize "income" except to the extent of appreciation after the date of the gift. It is recognized in the 1921 and prior laws that property acquired from a decedent is capital in the hands of recipients. It is difficult to discern any difference between *bona fide* gifts and bequests. The obligations imposed upon donees may be found to be unreasonable. In the case of husbands and wives or children it *may* be reasonable to require a statement of cost or value March 1, 1913, to accompany a gift. In many other cases the obligations are too onerous. Gifts to employees and servants frequently consist of shares of stock of closely held corporations or real estate or other

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[66] New York State's Comptroller's Regulations (amended November, 1921), Art. 91.

[67] *People ex rel. Wilson v. Wendell,* 188 N. Y. Supp. 273; *People ex rel. Brewster v. Wendell,* 188 N. Y. Supp. 510.

[68] **[Former Procedure]** Under 1918 and prior laws, the basis of gain or loss regarding property acquired by gift was value at the date of the gift.

property the cost of which to donors is uncertain and difficult to determine. Often there will be hesitancy to divulge the actual cost. In such cases the donee may be unduly penalized.

The new provision works two ways. If constitutional, it imposes on donees liability for tax when the donor would have realized a profit, but it opens up two opportunities to donors of which they will not be slow to take advantage. Heretofore, in order to transfer possible tax liability it was necessary to make irrevocable gifts. In many cases securities or other property declined in value after the date of the gift. The donor was unable to take advantage of the loss in case of sale. Under the present law donors will be able to wait almost indefinitely in the case of non-income bearing property before deciding whether or not to make the gift. If the property declines in value and the donor decides to sell it, he may deduct the loss. If it increases in value and the gift is made, the donee will pay the same tax as if the gift had been made earlier. Furthermore, donees may now make new gifts to former donors in which case the latter may deduct losses which under the 1918 and prior laws would only have been deductible by donees, i.e., the loss accrued after the first gift.

Appreciation in value of gift is not income to donor.—The following ruling applies to the determination of taxable profit upon sale of any gift received prior to January 1, 1921. It is immaterial whether the sale took place before, or takes place after, January 1, 1921, as the provision of the 1921 law taxing profits from property sold or otherwise disposed of on the same basis as though the property were in the hands of the donor or last preceding owner who did not acquire it by gift, applies only to gifts made after December 31, 1920.

Ruling. . . . . In the case of a real and actual gift of property which has appreciated in value between the time of acquisition and the time the gift is made, the appreciation will not be the subject of income taxation, and the donee who sells it will return as income only any appreciation realized over its value when the donee actually became the owner of it.

On the other hand, a mere colorable gift is not to be treated as a gift at all, and an attempt by such colorable gift to evade taxation is fraud for which either party who participates therein may be punished. (C. B. 1, page 83; S. 1022.)

In view of section 202 (a-2) of the 1921 law, the Treasury will doubtless hold that this ruling does not apply to gifts made after December 31, 1920.

HOMESTEAD—VALUE AT DATE OF ACQUISITION.—

RULING. The basis for determining gain or loss from the sale of a homestead acquired from the Government will be the fair market value of the homestead at the date of its acquisition or the value at March 1, 1913, if acquired prior to that date.

The date of acquisition of a homestead acquired by public grant is the date of entry upon the land. The taxpayer will not be entitled to add to the value of the homestead the amount expended for relinquishment in order to clear the Land Office records, nor any fees paid to the Government, but the cost of improvements may be added to the value as of the date of acquisition. (C. B. 2, page 33; O. D. 386.)

The foregoing is based on the theory that a "public grant" is in the nature of a gift from the government.[69] Therefore the value used to compute profit or loss on sale is the same as that used in the case of any gift, viz., the value at date of acquisition if after March 1, 1913, and before January 1, 1921. The procedure regarding such gifts after December 31, 1920, is a good test of one's imagination.

MINERAL RIGHTS—GIFTS FROM GOVERNMENT.—

RULING. The value of mineral rights acquired by a taxpayer in 1915 through location under the mineral laws of the Federal Government is in the nature of a gift from the Government and was not returnable as income for that year under the Revenue Act of 1913.

The Committee further finds that since it has not been shown that the mineral rights had any value at the time of acquisition and that since it is shown that the taxpayer was not put to any expense in acquiring the said rights or in the development of their value, the total proceeds of the sale of such mineral rights in 1917 constituted

[69] Letter to the Corporation Trust Company, signed by Acting Commissioner Paul F. Myers, dated July 8, 1920.

income subject to tax for that year under the Revenue Act of 1917. (C. B. I-1, page 94; Digest A. R. R. 759.)

Income from sale of property acquired by inheritance.—

LAW. Section 202. (a) . . . . (3) In the case of such property, acquired by bequest, devise, or inheritance, the basis shall be the fair market price or value of such property at the time of such acquisition.[70] The provisions of this paragraph shall apply to the acquisition of such property interests as are specified in subdivision (c) or (e) of section 402.[71]

VALUE AT DATE OF TESTATOR'S DEATH MUST BE USED.—In computing gain or loss on a sale of stock by trustees under a will, the value of the stock at the date of the testator's death should be used as the starting point rather than the value of such stock at the date of distribution to the trustees.

Any gain realized on such a sale must be reported as taxable income by the trustees, who will also be required to pay the tax due thereon. The fact that at some uncertain date in the future the corpus of the estate, including the accumulation of income of a certain character will, if it is then in existence, be paid over to exempt corporations, does not relieve the trustees from the obligation of paying the tax. (C. B. 2, page 34; O. 1012.)

This ruling is contrary to a recent court decision based on the 1916 and 1917 laws. (*Lederer v. Stockton,* 67 L. Ed. —, decided by the Supreme Court of the United States on October 16, 1922.)

RULING. Under the terms of a will the residue of the estate was bequeathed to the testator's three sons, to be divided equally among them. This residue consisting of cash and a number of securities was in accordance with mutual agreement divided upon the basis of the market price of the securities at the time of distribution, which was in excess of their value at the date of decedent's death, as appraised for Federal estate tax purposes. Following this arrange-

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[70] **[Former Procedure]** Reg. 45, Art. 1562, provided that the value at time of acquisition should be the basis for property acquired by gift as well as by bequest, devise or descent.

[71] Section 402 (c) and (e) deals with the determination of the gross estate of a decedent for estate tax purposes. For details see Chapter XLV.

ment one of the residuary legatees received no cash, another less cash than the third, but all received an equal share of the residue in accordance with the terms of the will. The question presented is whether the estate derived any taxable gain from the transfer of the securities to the residuary legatees and whether on a subsequent sale by the legatees the basis for determining gain or loss is the fair market value of such securities at the time they were received by the legatees in the distribution or at their appraised value as at the date of the death of the testator.

Held, that the estate of the decedent derived no taxable gain from the transfer to the residuary legatees of the securities forming a part of the residue of such estate. The basis for determining gain or loss upon a sale of securities received by legatees is the value of such securities at the date of the testator's death, as appraised for the purpose of the Federal estate tax, whether the devise or bequest be specific or residuary. (C. B. 3, page 52; O. D. 667.)

Where securities held in trust for the beneficiaries are subsequently distributed together with other securities representing investments by the executors, it is necessary to segregate the securities for the purpose of determining any profit on sale by the beneficiaries.

Ruling. . . . Held, that the basis to be used in determining the gain or loss resulting from the sale of those securities which were part of the estate of the testator at the time of his death is the value of the beneficiary's vested interest in such securities as at the date of the decedent's death; that the basis to be used in determining the gain or loss resulting from the sale of those securities representing an investment made by the trustees after the death of the decedent is the cost of such securities to the trustees. (C. B. I-1, page 30; I. T. 1165.)

Securities are to be valued at date they are available, irrespective of date received.—

Ruling. On the date of her divorce in 1919 a beneficiary under a trust instrument executed by her father became entitled to the delivery by the trustee of securities. Their value on this date is the basis for determining gain or loss from a sale, notwithstanding the fact that by mistake she did not receive them till two years subsequently. (C. B. 5, page 55; Digest O. D. 1136.)

Value as between life tenant and remainderman.—

Ruling. Where in a bequest of property the remaindermen have only a contingent interest prior to the death of the life tenant, the basis for determining gain or loss from a sale of such property by

the remaindermen is its value as of the date of death of the life tenant. (C. B. 3, page 53; O. D. 727.)

When interest is not contingent.—

Ruling. Where real estate is devised by a testator to his widow for life with a direction that upon her death the property shall be sold and the proceeds divided among the testator's children, the basis for ascertaining the gain or loss on a sale of such real estate and distribution of the proceeds to the children is the value of their rights at the time they vested, or on March 1, 1913, if they vested prior thereto.

The possession of land devised to the children of a testator subject to a life estate in their mother, which vested in fact on the death of the life tenant, was acquired by the children *in right* on the death of the testator. The provision of the income tax law exempting from tax the value of property acquired by a devise or bequest merely exempts the value of the right at the time it was acquired and not any value which subsequently may attach to it pending actual or anticipated arrival of the period of enjoyment. (C. B. 3, page 50; Digest Sol. Op. 35.)

In the detailed opinion the solicitor said:

Section 2(c) of the Revenue Act of 1916, in so far as the present question is concerned, is substantially the same as the provisions of section 202 of the Revenue Act of 1918, here involved. Law Opinion 649, upon a consideration and application of the former section, held that the basis for determining the profit from a sale of real estate by a remainderman after the termination of a life estate is the value of the property upon the date when the remainder vested in possession. That opinion is inconsistent with the view here entertained and is hereby overruled.

Computation of Tax on Capital Gains

Prior to January 1, 1922, the rates of tax imposed under all federal income and profits tax laws were the same upon capital gains[72] as upon ordinary net income. Under the 1921

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[72] "There are capital profits and revenue profits. Thus, for instance, part of a tract of land upon which a factory has been erected is sold for an amount equal to the original cost of the entire undertaking. This is realized income, but it does not fall within the ordinary definition, therefore it is not wise to rely upon any one definition. The net income from a man's vocation is revenue profit; the net profit realized from an outside venture is capital profit." (*Auditing, Theory and Practice*, Vol. I, (1921 edition), by R. H. Montgomery, page 309.)

law the maximum rate of tax upon net capital gains realized after January 1, 1922, is 12½ per cent.[73] As the rate includes the normal tax of 8 per cent, the maximum surtax is 4½ per cent. The provision does not apply to corporations, but as the flat tax upon corporations is 12½ per cent the inhibition is of no importance for the year 1922.

The law contains the following definitions:

LAW. Section 206. (a) That for the purpose of this title:

(1) The term "capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921;

(2) The term "capital loss" means deductible loss resulting from the sale or exchange of capital assets consummated after December 31, 1921;

(3) The term "capital deductions" means such deductions as are allowed under this title for the purpose of computing net income and are properly allocable to or chargeable against items of capital gain as defined in this section;

(4) The term "capital net gain" means the excess of the total amount of capital gain over the sum of the capital deductions and capital losses;

(5) The term "ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions; and

(6) The term "capital assets" as used in this section means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year. . . . .

The provisions of the 1921 law with respect to the method and rate of taxation to be applied to capital gains realized after December 31, 1921, are as follows:

LAW. Section 206. . . . . (b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary

[73] For computations, etc., see page 628 *et seq.*

net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain; but if the taxpayer elects to be taxed under this section the total tax shall in no such case be less than 12½ per centum of the total net income. The total tax thus determined shall be computed, collected and paid in the same manner, at the same time and subject to the same provisions of law, including penalties, as other taxes under this title.

Although the courts and economists do not agree on the distinction between capital and income, the language of the law is not ambiguous and there should be little difficulty in computing net capital gains.

In large part the regulations pertaining to the capital gain provisions of the law merely repeat in slightly different phraseology the language of the law itself and present a few illustrative figures to show the application of the provisions to concrete cases. The regulations do, however, touch specifically on two points which are not mentioned in the law itself. One is with reference to the case of a taxpayer who has a net capital gain and a net loss in ordinary income account. The regulations hold that the net loss in "ordinary net income" cannot be applied against net capital gain if the benefit of the 12½ per cent rate of tax on the capital gain is to be availed of. The other point is with respect to the question as to whether the two-year period runs from the inception of an investment, the form (but not the substance) of which has changed but from which change under section 202 (c) no taxable profit or deductible loss is deemed yet to have arisen, or whether the two-year period runs from the time the investment took the form it had at the time of sale. Article 1651, quoted below, holds that in such case the time during which the investment was in its previous form is included in the two-year period.

Regulation. (*a*) Section 206 applies only to sales or exchanges of capital assets consummated after December 31, 1921. It provides that any taxpayer other than a corporation may, if he so desires, state separately in his return his net gain on sales or exchanges of capital assets and pay on such capital net gain (as defined and limited in the

section) a flat tax of 12½ per cent in lieu of the tax he would otherwise pay on such income under sections 210 and 211. On his net income from other sources, termed "ordinary net income" in this section, he would be taxed under those sections. If, however, he elects thus to segregate his capital net gain, his total tax on the aggregate amount of both kinds of income must be at least 12½ per cent thereof.

DEFINITIONS: "CAPITAL ASSETS."—

The term "capital assets" is defined to mean property of any kind whatever acquired and held by the taxpayer for profit or investment for more than two years, whether or not connected with his trade or business, not including property (for example, a dwelling) held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind properly included in an inventory. The specific property sold or exchanged must have been held for more than two years, but in the case of a stock dividend the prescribed period applies to the original stock and the stock received as a dividend considered as a unit and where property is exchanged for other property and no gain or loss recognized under the provisions of section 202, the prescribed period applies to the property exchanged and the property received in exchange considered as a unit.

"CAPITAL GAIN" AND "CAPITAL LOSS."—

"Capital gain" is taxable gain from the sale or exchange of capital assets, while "capital loss" is deductible loss resulting from the sale of capital assets. As to the basis for determining such gain or loss (including adjustment for depreciation) see article 1561; as to betterments and repairs, see articles 24 (3) and 103. Ordinary repairs and taxes are annual charges against income, and do not enter into the computation of such gain or loss.

"CAPITAL DEDUCTIONS" AND "CAPITAL NET GAIN."—

"Capital deductions" are deductions properly allocable to or chargeable against items of capital gain, including items of expense connected with the sale or exchange of a capital asset (for example, commissions paid brokers or agents). While interest, taxes, and other carrying charges are usually annual charges against income, they may be allocated to capital gain derived from the sale or exchange of a capital asset for the taxable year in which such asset is sold or exchanged to the extent that such current charges exceed the income directly derived from such asset. "Capital net gain" is the excess of the total amount of the capital gain over the sum of the capital deductions and capital losses.

Computation of capital net gain and tax.—For illustration: A in 1922 sold (1) an office building for $1,000,000 which he had bought in 1915 for $500,000 and on which there was depreciation aggregating $100,000; and (2) stock in a mining company for $10,000 which he had purchased in 1919 for $20,000. Taking no account of capital deductions (for example, commissions paid on these sales), his capital gain would be $600,000, his capital loss $10,000, and his capital net gain $590,000. Suppose that his other net income ("ordinary net income") in 1922 was $50,000. Instead of paying normal tax and surtax on his total net income of $640,000, he may segregate these capital transactions in his return and pay a tax of 12½ per cent on his capital net gain of $590,000, plus the normal tax and surtax upon his ordinary net income of $50,000. Suppose, on the other hand, that A, with capital net gain of $590,000, not only had no "ordinary net income," but actually sustained a net loss of $50,000 in his business. He may not deduct such net loss in "ordinary net income" from his capital net gain if he elects to be taxed under section 206, but must pay 12½ per cent of $590,000. . . . . (Art. 1651.)

The illustration in article 1651 quoted above may be stated in tabular form as follows:

1922	Selling price of office building		$1,000,000	
1915	Cost price of office building	$500,000		
	Less: Depreciation	100,000	400,000	
	Capital *gain*			$600,000
1919	Cost of mining stock		$ 20,000	
1922	Selling price of mining stock		10,000	
	Capital *loss*			10,000
	Capital *net gain*			$590,000
1922	Other income ("ordinary net income")			50,000
	Total net income			$640,000

		Tax
A pays 12½% on $590,000		$ 73,750
Plus: Normal tax:		
Ordinary net income	$ 50,000	
Less: Exemption (if married and having no dependents)	2,000	
	$ 48,000	
Taxable at 4%	4,000	160
Taxable at 8%	$ 44,000	3,520
Surtax (1922 rates) on $50,000		4,960
Total tax		$ 82,390

The tax computed without benefit of the capital gains provision would be:

Normal tax:		
Normal income	$ 640,000	
Less: Exemption	2,000	
	$ 638,000	
Taxable at 4%	4,000	$160
Taxable at 8%	$ 634,000	50,720
Surtax on $640,000		290,960
Total tax		$341,840
Difference		$259,450

In the second case assumed in the illustration		
Capital *net gain* is the same as before		$590,000
But instead of other income ("ordinary net income") of $50,000, A sustained a net loss in business of	$ 50,000	
Such net loss is not deductible from the $590,000 capital net gain which is taxed at 12½%.		

The net loss of $50,000 from business, mentioned in the illustration, should not be confused with the "net loss" described in section 204 (see Chapter XXXIV), which may be carried forward to the succeeding year. The $50,000 net loss shown in the illustration is merely a factor in the alternative computation under the capital gains provisions section 206.

On the other hand, assume that A's capital gain is		$100,000
and that A's net loss from business, as before, is	$50,000	
If A computed the tax under the capital gains provision, the tax would be 12½% of $100,000, or		$ 12,500

If A does not elect to be taxed under the capital gains provision, the tax will be computed as follows:

Normal tax:		
Net income ($100,000 — $50,000)	$50,000	
Less: Personal exemption	2,000	
	$48,000	
Taxable at 4%	4,000	$160
Taxable at 8%	$44,000	3,520
Surtax on $50,000		4,960
Total tax		$8,640

It is obvious that A in the illustration just given would not invoke the capital gains section of the law. The point is that losses which may not be deductible in computing capital gains may be taken in computing net income in the regular way. Alternative computations will have to be made so the taxpayer can determine which yields the lower tax.

Application of credits and exemptions in alternative computations.—

Regulation. . . . . (*b*) The credit allowed by section 222[74] . . . . is a credit against the total tax, however computed, but the credits allowed by section 216[75] are allowed "for the purpose of the normal tax only" and may not be taken against capital net gain, although they may be deducted from ordinary "net income." For example, if B, a married person, had capital net gain of $30,000 and ordinary net income of $2,000, his $2,500 personal exemption would more than offset his ordinary net income, but he may not apply any part of it to reduce his capital net gain. . . . . (Art. 1651.)

Tax not less than 12½ per cent of total net income.—

Regulation. . . . Section 206 (b) provides that if the taxpayer elects to be taxed under that section his total tax shall in no case be less than 12½ per cent of his total net income. In the example just given, the tax on B's capital net gain of $30,000 at 12½ per cent would be $3,750, but the corrected amount of his total tax under this limitation is 12½ per cent of his total net income of $32,000, or $4,000. It will be found, however, that B, with ordinary net income of $2,000 and capital net gain of $30,000, would not elect to be taxed under section 206 because under the surtax rates for 1922 his total tax computed in the usual way would be only $3,940 (normal tax $2,240 plus surtax $1,700), or $60 less than if computed under section 206. . . . . (Art. 1651.)

The tax in the foregoing illustration is computed thus:

(1) On basis of capital gains	$3,750
(2) On basis of applying the limitation of 12½% to total net income	$4,000
(3) On ordinary basis, disregarding capital gains provision........	$3,940

B pays the last of the three taxes.

[74] Section 222 refers to credit for foreign income and profits taxes.

[75] Section 216 provides for credit of certain dividends and interest, and for the personal exemptions and credits for dependents.

Effective date.—The law refers to transactions "consummated after December 31, 1921." It is clear that sales or exchanges which were entirely completed before January 1, 1922, cannot be reported in 1922, but are subject to the rates in force prior to 1922. Irrespective of the new regulations, the attitude of the Treasury must be that the word "consummated" as applied to the taxation of income, means actual realization and not a "paper" closing of a transaction. There will be cases in which doubts will arise as to the actual consummation of a transaction, and in some cases the decision will throw the gain back of 1922 and in almost similar cases the gain will be held to be realized in 1922. Generally speaking, transactions prior to January 1, 1922, which did not result in the receipt of cash or property of a readily realizable market value, were not consummated on the effective date, and the gains arising from such transactions should not be reported until they are actually consummated.

Meaning of term "capital assets."—Upon the interpretation given to the term "capital assets" will depend the classification of items which heretofore have not been carefully earmarked as capital items because no necessity existed for a correct classification. It is immaterial what terminology may have been used by taxpayers in the past. The sole test hereafter will be the true designation of items. The law clearly sets forth three negative tests which permit easy classification:

1. Capital assets must have been owned for at least two years.
2. Stock-in-trade must be excluded.
3. Property held for personal use or consumption must be excluded.

MEANING OF TWO-YEAR REQUIREMENT.—In imposing a low rate of tax it was the intention of Congress to encourage the transfer of investments. It had been claimed that property held for a long period of years could not profitably be disposed of

under the high rates of tax. The argument did not extend to gains arising from property recently acquired. With this in mind it should not be difficult to follow the two-year limitation. Taxpayers who claim the benefits of the special rate must show that the assets from which the taxable gains arise have been "acquired and held by the taxpayer" for more than two years prior to date of sale. The property disposed of must be the identical property acquired more than two years previously, unless the existing property is held *for income tax purposes* to have taken the place of other property.

In all cases which are held not to be closed transactions the two-year period runs from the date the original property was acquired. There are difficulties in applying this principle. When real estate which is real property has been exchanged for shares of stock which are personal property, it can hardly be held that the capital asset disposed of is the real estate even though one is held to take the place of the other and no tax was imposed upon the exchange.

It may be held that capital assets disposed of must have been held for two years in their identical form although the basis of tax may go back to the original cost of property for which the property sold was exchanged. The section must be reasonably construed. A building is a capital asset. Suppose it is substantially rebuilt within two years prior to sale. The building as sold has not been held for two years but the capital asset has been held for two years. In other words, a mere change in form should make no difference.

Assets (other than stock-in-trade) owned by partnerships and distributed to partners at book values, are capital assets in the hands of the partners. The two-year period runs from the time the assets were acquired by the partnership.

The provision that the property must be held for two years by "the taxpayer" will no doubt be strictly applied. The undivided estate of a taxpayer would be "the taxpayer," but when a beneficiary receives property and subsequently sells it, the two-year period starts to run on the date of acquisition by the beneficiary.

RULING. The creator of a trust, either by will or deed, is regarded for the purpose of section 206 as entirely separate and distinct from the trustee who received securities under the trust instrument, and where securities sold by the trustee have not been held by him for a period of two years, the time during which such securities were held by the creator of the trust can not be added to the period during which they were held by the trustee in order to bring them within the two-year period required by section 206. (I-27-387; Digest I. T. 1379.)

MEANING OF TERM STOCK-IN-TRADE.—Without going into refinements of terms it is sufficient to state for income tax purposes that stock-in-trade is that which the Bureau of Internal Revenue has held to be stock-in-trade. There have been many exclusions of what might have been called stock-in-trade under commercial practice. For instance, the Treasury has ruled[76] that "a taxpayer, engaged in the real estate business, is not permitted to inventory real estate which is held for sale for the purpose of calculating net income subject to federal income tax." Under this ruling the gain on real estate owned for more than two years will carry the 12½ per cent rate.

Taxpayers engaged in business should be careful hereafter to analyze their income statements. It is not considered good accounting practice to credit to current income gains arising from sales of capital assets; but it is quite easy for a bookkeeper to make such entries. In the past it has made little difference. In the future it may make a substantial difference.

The Treasury has ruled that inventories may be taken only of merchandise and of securities; in the case of securities permission to inventory is strictly limited to dealers in securities. Many who have called themselves dealers in securities have been refused the classification by the Treasury.[77]

Article 1585 of Regulations 45 made a distinction between corporations and partnerships which were dealers in securities and "officers of (such) corporations and members of (such) partnerships, who in their individual capacities buy and sell

[76] C. B. 4, page 47; O. D. 848.

[77] *Income Tax Procedure*, 1921, page 359.

securities," holding that the officers and individual partners were not dealers in securities. They were not permitted to inventory their securities and obviously therefore their securities could not be considered "stock-in-trade."

In the case of bankers and others who have for more than two years carried securities which have not been inventoried, the gain, if any, upon sale will be taxed at 12½ per cent.

In any event, accounting practice determines which assets should be inventoried. Those which should not be inventoried are capital assets, irrespective of erroneous methods of accounting. In some cases inventories of stock-in-trade improperly include capital items such as machinery parts, building materials, etc. In case of resale at a gain the items should be segregated; otherwise the practice has no effect on the computation of capital gains.

Former definitions of term "capital assets" not binding.—The Treasury in the following case has defined the term "capital assets."

Ruling. In the case of a bank the term "Capital Assets" as used in article 545 of Regulations 45 includes bonds and other securities in which it has invested money received on deposit. Any gain derived by the bank from the sale of such securities must be reported in its gross income and the amount of the gain is to be ascertained in accordance with the rules laid down in that article. (C. B. 4, page 276; O. D. 832.)

Ordinarily definitions such as the foregoing will not affect the specific definitions contained in the law. In the case of banks all of their investments are capital assets unless they qualified as dealers in securities and were permitted by the Treasury to inventory their securities.

The mere act of calculating depreciation or depletion has much to do with the determination of stock-in-trade. The latter is periodically revalued for income tax purposes. Under the regulations assets which could not be inventoried automatically become capital assets.

DISCOUNT ON BONDS WHEN REALIZED HELD TO BE A GAIN NOT INTEREST.—When the purchaser of a bond at 90 sells it or it is redeemed at 100, the appreciation may merely represent the difference between the effective and the normal rate of interest. The Treasury, however, holds the realized appreciation is a gain. If the bonds had been held by the taxpayer for two years, the gain is a capital gain.

RULING. . . . . If the obligations, whether interest bearing or non-interest bearing, were issued at a discount, any excess of the selling price over the cost of the obligations to the vendor is a taxable profit to the extent of such excess, even though the agreement of sale specifies a division between the price of the obligation and the accrued discount. (C. B. I-1, page 27; I. T. 1187.)

MEANING OF TERM "PERSONAL USE OR CONSUMPTION."—Taxpayers are not permitted to deduct as losses, nor permitted to return as capital gains, the losses or gains arising from the sale of residences occupied by the taxpayers, automobiles, jewels and similar items (article 1651). The inhibition is fair so far as losses are concerned, but not fair regarding gains; if such gains are taxable at all they certainly should be taxed as capital gains.

All property, including residences leased to others, and investments of every description, excluding only assets for personal use or consumption, are classed as capital assets.

Determination of "capital net gain."—The law states that capital net gains consist of capital gains minus capital losses. Having decided which assets are capital assets, the calculation of the net gain or net loss is comparatively simple, and being fully discussed elsewhere, need not be repeated.[78] A short formula is the following:

Debit an account with value of asset at March 1, 1913, or cost if acquired since; add capital expenditures such as carrying charges if capitalized (that is, if not deducted in tax

[78] See page 567 where effect of depreciation on sales is discussed, and computations on page 568 showing effect of depreciated March 1, 1913, value, and depreciated cost, respectively.

returns since 1913)[79]; credit depreciation or depletion to date of sale; credit net sales price. The balance of the account will be the capital gain or capital loss.

Capital net losses.—The law does not impose the limitation of 12½ per cent upon capital net losses. Taxpayers who seek to secure the maximum benefit under the new law will endeavor to bunch their capital gains in one taxable year and their capital losses in another taxable year.

In his report for 1922 (page 14) the Secretary of the Treasury recommends that "the amount by which the tax may be reduced on account of losses from the sale of capital assets should not exceed 12½ per cent of the amount of the loss."

Statement of capital transactions to be attached to return.—

REGULATION. Segregation of capital transactions for the purposes of section 206 is required only where the taxpayer elects to be taxed under that section. Where his total income tax for any taxable year does not exceed 12½ per cent of his net income he will not elect to be so taxed for that year. . . . . When a taxpayer elects to be taxed under this section for any taxable year, he shall attach to his return of income for such year an accurate statement under oath showing all items of capital gain, capital loss, and capital deductions in such manner as will clearly show the exact amount of his capital net gain for the taxable year. Each capital transaction must be separately shown and the capital items with respect thereto grouped together in order that the capital gain derived or the capital loss sustained from each capital transaction will readily appear. In the case of sales or exchanges of real estate, the statement must show whether or not it was held as a residence by the taxpayer or his family. In the case of sales or exchanges of securities or any other property, the statement must show how long the property was held by the taxpayer immediately preceding the sale or exchange. (Art. 1652.)

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[79] See the author's comments on page 582.

CHAPTER XXIII

INCOME FROM ROYALTIES AND PATENTS

Income from royalties and similar sources is not specifically named in the definition of income in the law, but it is clearly included within the following general clause:

LAW. Section 213. . . . . the term "gross income"— . . . . (a) Includes . . . . gains or profits and income derived from any source whatever.

REGULATION. . . . . gross income . . . . embraces . . . . income . . . . such as . . . . royalties . . . . (Art. 541.)

The law provides that the profit which arises from the sale of patents and copyrights must be included as income for the year in which it is received. It has been pointed out on many occasions that this procedure works an unwarranted hardship on inventors and others who have spent considerable time and money in the development of ideas or devices, only to find that on selling them the whole of the increased value must be returned for tax purposes in a single year. It is admitted that a distribution of the increment over the development period would be extremely difficult, but the injustice of the present procedure warrants special treatment of some kind. Under the 1918 and prior laws no relief is granted, nor is any effective for the taxable year 1921; but for 1922 and subsequent years the "capital net gain" provision of the law (section 206) will limit the tax payable to 12½% of the profit, if the patent or copyright has been held for at least two years.[1]

Royalties from Mines, Oil Wells, etc.

Royalties from mines, oil wells, etc., must be accounted for in the year in which they are received by the original

[1] See further Chapter XXII.

recipient. If they are afterwards transferred to another as the result of litigation, the tax originally paid thereon will be adjusted if a claim for credit or refund is filed.

RULINGS. Income from oil royalties must be returned in the taxable year received, even though the title to the producing land is in litigation. If any part of the royalty income is ordered by the court to be paid over to another, any tax previously paid thereon will be credited against any income tax then due under any other return of the taxpayer, and any balance of the excess tax paid will be refunded if proper claim for such refund is made. (C. B. 4, page 95; O. D. 825.)

This ruling was later explained as follows:

. . . . In the case of a dispute as to the title of oil-producing land, the royalties belong to the true owner. They follow the land and come into existence regardless of the person or activities of the owner. If one collects the royalties thinking he is the owner and then by judgment of court finds that another is the owner, he must surrender the royalties received not as damages but simply because they belong, and belonged from the beginning to the true owner. The one who first received the royalty did so because he thought the land, and therefore, the royalties were his.

Where a patentee obtains a judgment against the infringer of a patent by virtue of which the infringer must account for all profits made through the infringement, the situation is materially different.[2] . . . . (C. B. 5, page 134; O. D. 1141.)

In the foregoing case the royalties were paid to one who claimed to be the owner of the lands. The obligation to report was clear. In the following case the lessee withheld the payments. It is not likely that the claimant, eventually successful, would have reported the income on an accrual basis. Nevertheless, when determined the claimant should be permitted to file amended returns. The only equitable tax is that which would accrue from year to year under the laws in force during those years. Otherwise under the graduated rates in force in the year of realization the government might take several times as much tax as would justly be due. The taxpayer's failure to report would be due to no fault of his and he should

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[2] For remainder of ruling see page 646.

not be penalized. The Commissioner has the power to, and should, accept amended returns.

RULING. The taxpayer leased oil land to a corporation under a royalty agreement. The title of the lessor to the land is in litigation and, pending the settlement of the litigation, payment of royalty is being withheld by the lessee. Inquiry is made by the lessor as to the proper treatment for income-tax purposes of the royalties so withheld.

Held, that inasmuch as the taxpayer's right to the royalties is in dispute, it not being certain he would ever receive them, and since if the royalties are rightfully his they will not be available to him until the litigation is finally determined, such royalties withheld by the lessee are not to be included in income for the years in which they would otherwise have been payable, but should be reported as income for the year in which the litigation in question is finally disposed of or the lessor's right to the royalties is established in some other way. (C. B. I-1, page 90; I. T. 1212.)

Royalties subject to depletion charges.—The owner of a mine, an oil well or other similar property operated on a royalty basis must return as income his royalties received, but he is permitted to deduct expenses and to charge against the royalties received (or accrued, if taxpayer reports on accrual basis) depletion allowances based on the full value of his property as at March 1, 1913, if purchased before that date, or on the basis of the capital originally invested if purchased thereafter,[3] except in the case of mines and oil wells discovered by the taxpayer, in which case the value of the property at the date of discovery or within thirty days thereafter is the basis prescribed by law.[4] For a full discussion of the topic of depletion as an allowable deduction, consult Chapter XXXVIII.

After the value as at March 1, 1913, is determined, a proper calculation must be made as to how much of the royalties received is capital and how much is income. The part which is

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[3] *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503, 61 L. Ed. 460, 37 Sup. Ct. 201.

[Former Procedure] In a ruling issued February 12, 1915, it was held that the lessor had "a measure of profit in every ton of ore disposed of" on the royalty basis, which is obviously untrue. See *Income Tax Procedure*, 1922, page 642 footnote.

[4] See section 214 (a-10).

capital is not taxable, but all royalties which accrue must be reported as gross income and the depletion allowance deducted in order to ascertain the taxable or net income.

In the *Manual for the Oil and Gas Industry*[5] the Treasury states (page 31) that "if a certain proportionate part of the lessee's capital returnable through depletion deductions is deducted in a given year the same *proportion* of the lessor's capital sum returnable through depletion will be deducted."

This rule may or may not be equitable. No general rule can deprive the lessor or lessee of the right to a depletion allowance which will return his capital free of tax.

RULING. Land was purchased in 1914. At the time of the purchase the mineral rights in the land had no market value, that is, no part of the purchase price of the land was paid as consideration for the mineral rights therein. Subsequently the land was leased on a royalty basis for oil and gas development and in 1919, amounts were received from the sale of interests in such royalty.

Held, that inasmuch as the oil and gas rights had no market value at the time the land was purchased the entire amount received from the sale of the royalty interests is income for the year of its receipt, subject, however, to proper adjustment on account of depletion sustained. (C. B. 3, page 89; O. D. 644.)

The ruling is inconsistent. It first states that there is no capital investment, and then that an adjustment is to be made for "depletion sustained." The amount of depletion, when there is no capital sum to be depleted, must be rather difficult to determine.

The following ruling deals with a participating lease of oil lands.

RULING. B acquired a lease of oil land, agreeing that the lessors should receive a one-sixth royalty interest in the lease. In consideration of the lease he also agreed to pay x dollars to the lessors from one-half the proceeds of all sales of oil and gas produced by the five-sixths working interest belonging to him in the lease and one-fourth and one-twelfth of the proceeds of the sales of oil and gas produced by him upon two other leases he owned. Under the agreement he was obligated to pay Federal income tax upon the sums payable, together

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[5] Revised August, 1921.

with interest, the taxes and interest being payable in the same manner as the x dollars.

The oil is piped direct to the purchasing company, which remits to C, who places to the credit of the lessors amounts properly payable to them. Upon forfeiture of the lease B is bound to pay the x dollars taxes and interest, and he may not sell the lease without paying these amounts.

Held, that all income received from the five-sixths interest belonging to B and the one-fourth and one-twelfth interest in the two other leases represent income to B for the year in which received or accrued, proper deductions being taken for depletion each year.

The x dollars may not be amortized over the period required for its payment, but so much of each payment as represents a payment on such principal amount, income tax payable, and interest upon the payments, should be claimed as a deduction for the year in which paid. (C. B. 5, page 80; Digest O. D. 971.)

Royalties from coal lands.—In the anthracite fields many owners of coal lands have granted perpetual "mining leases" to operators. The Supreme Court of Pennsylvania has held these transfers to be "sales."[6] In all cases the revenue therefrom (usually a fixed rate per ton mined) is known as "royalties." Under the 1916 and subsequent laws, the owners of coal lands, or those to whom a "royalty" is being paid, are entitled to receive in cash, free from income tax, an amount equal to the fair value of the property on March 1, 1913, if the property had been acquired prior to that date. This valuation is assumed to be capital. After such principal sum is provided for, the balance of the collections is income and is subject to the income tax. If the rate of royalties is a substantial one, it is probable that, of the royalties received each year, part is capital and part is taxable income.

A lease to mine coal in Pennsylvania provided that the lessor should retain the privilege of selling the property at the expiration of ten years. The Treasury held[7] that such a lease was not a sale of the coal in place, but the deduction for depletion was held to be the same as if the lease were a perpetual one.

[6] *Hosack v. Crill,* 204 Pa. St. 97, 53 Atl. 640.
[7] C. B. 2, page 143; S. 1365.

Mining royalties (minimum) received in advance.—In most mining districts it is customary for owners of the lands to execute contracts or leases under which the lessees are required to make annual payments representing a fixed per-ton compensation or royalty for a definite number of tons of ore or coal. These payments are made to the owners and are clearly understood by both parties concerned to be in full payment of royalties for an equivalent amount of ore or coal whenever it may be removed thereafter. These payments are usually designated as advance minimum royalties, and may be paid for several successive years in which no ore or coal is mined.[8] In many cases the property is surrendered to the lessors before the quantities paid for have been removed.

DEPLETION APPLICABLE TO ADVANCED ROYALTIES.—

REGULATION. . . . (*b*) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

BOTH CAPITAL AND INCOME ACCOUNTS MUST BE ADJUSTED.—

(*c*) If, for any reason, any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include

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[8] **[Former Procedure]** See *Income Tax Procedure,* 1919, page 288.

the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid. (Art. 215.)

The foregoing regulation properly holds that when a lessor has claimed annual depletion equal to the quantity covered by the advance royalties, no further deduction shall be made when the ore is subsequently removed.

The regulation further provides that when a lessor repossesses the property, and part of the ore or mineral, in respect of which depletion was deducted, has not been removed by the lessee, the aggregate of the excessive deductions will be deemed income to the lessor "and his income account shall be adjusted so as to include the amount . . . . as income of the year such lease is terminated or the property repossessed, and the tax thereon paid."

This latter provision may work great hardship. A lessor may lease coal lands for a period of thirty years at a stated royalty per ton for coal removed, the minimum royalty being fixed at $25,000 per annum. If the proper depletion based on the minimum royalty is $10,000 per annum, there is returned as net income $15,000 annually. If the lessee should mine only one-half of the coal paid for (and in many cases the proportion is less), in the thirty-first year the lessor would be presumed to have realized a net income of $150,000 and the tax thereon might be $50,000. Theoretically, excessive depletion, to the extent of $5,000 per annum for thirty years, has been claimed; but the tax saved by the excessive deduction may not have amounted to more than one-half of the tax which would be payable if the adjustment were made in the year of repossession.

Furthermore, the taxpayer probably would have no means of paying the tax, because a repossessed coal mine often has little sale value.

In most cases the apparently excessive deductions would not be excessive at all. Depletion could only be charged from year to year on the basis of the original value of the lease.

The lessee would not relinquish possession and lose his advanced royalties if the mine retained its value. Therefore, at the end of the period the lessor would have merely charged off an aggregate sum equal to the depletion of the coal removed plus the depreciation in the value of his property.

In any event the actual value of the property repossessed is the maximum amount which can be deemed to be income. If amended returns for prior years are not accepted, the author ventures the prediction that no court would deem the value of the property repossessed to be income taxable solely in the year of repossession.

When the failure to recoup the advanced royalties or the lapse of the lease is due to inefficient operation, inadequate capital owned by the lessee, or for similar reasons other than the content, availability, etc., of the mine, and when the allowance in previous years for depletion, which never actually accrued, has resulted in real income not yet reported, amended returns should be made by the lessor. Also, if advanced royalties become unrecoverable because minerals have not been removed during a definite period stipulated in the lease, within which advanced or minimum royalties may be recovered, there may be some additional income of the lessor for previous years for which amended returns should be made.

Royalties waived for several years—received in one year.—

Ruling. A lessor of mining property who waived his right to royalties for several years on account of the fact that the mine was operated at a loss, and received all of the royalties in the year 1917, may, if he has submitted returns for those years on a cash receipts and payments basis, deduct from the income received in 1917 such depletion allowance as appertains to that income. (C. B. 2, page 144; A. R. M. 17.)

Royalties from Copyrights

An author should report as gross income all sums received from copyright privileges. He is entitled to claim as deduc-

tions all expenses, except ordinary living expenses, incurred in producing such income.

The argument which appears on page 637 for a more equitable tax upon the earnings of inventors applies with equal force to the earnings of authors. It must be admitted, however, that there will be great difficulty in framing and administering a remedial provision. A lawyer who works for ten years and finally wins an important case has an equal claim to consideration.

REGULATION. . . . . Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. . . . . (Art. 293.)

However, deductions can be made for depreciation[9] and conservative accounting calls for rates of depreciation on assets of this kind up to 100 per cent per annum.

The method prescribed for computing the profit, if any, from the sale of copyrights, is the same as that for patents.[10]

Royalties and Profits from Patents

Income from the sale of patents above cost, or from royalties when such royalties include profit over and above the return of capital, is taxable.[11] The general principle of a return of capital must be followed, however. No tax can be imposed on receipts from the sale of patents or patent rights unless the owner has made full provision to reimburse himself for the cost or value of them. If the patents were applied for or owned on or before March 1, 1913, their actual value at that date is their capital value. If they were acquired after that date, the cost is considered the capital value.[12]

A payment to bind an option to purchase an interest in

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[9] See Chapter XXXVI.

[10] Art. 40, page 649.

[11] [Former Procedure] For a short time the Treasury in taxing royalties ignored March 1, 1913, values. For rulings in 1916, see *Income Tax Procedure*, 1920, page 395.

[12] Art. 1561, page 564.

the royalties to be received from certain patents has been held to be income to the recipient.[13]

Damages received from infringements of patents.—Collections of damages arising from infringements may be income or capital or both, depending on the fair value as at March 1, 1913, and the nature of the damages collected. If no injury to the capital value has resulted, the entire collection, less expenses, is income.

If the capital value has been diminished by the infringement, the amount collected, or an appropriate part thereof, should be applied in reduction of the book value of the patents.

REGULATION. . . . . A person may sue in one year on a pecuniary claim or for property, but money or property recovered on a judgment therefor rendered in a later year would be income in that year, assuming that it would have been income in the earlier year if then received. This is true of a recovery for patent infringement. . . . . (Art. 51.)

RULING.. . . . . The infringer of a patent directly creates by his activities the profits made; but for him they might not have come into existence. These profits as earned belong to him and are properly returned as income in the years earned. But having committed a wrong in infringing the patent he is compelled to compensate the owner for the damage done him and the measure of such damage in equity is the profit derived by such infringement and such further amount as the Master may find. A judgment requiring an accounting of profits, in such a case, is the equivalent or substitute for legal damages. It does not mean that the profits made by the infringer belong to the owner of the patent from the time such profits are made and that the infringer is converted into a trustee for the owner with respect to such profit. (*Tilghman v. Proctor*, 125 U. S. 136; *Root v. R. Ry. Co.*, 105 U. S. 214.) With this understanding of the nature of judgments requiring an accounting of profits in patent infringement cases it is clear that the loss sustained by the infringer must be taken in the year judgment is rendered. (C. B. 5, page 134; O. D. 1141.)

The foregoing regulation and ruling may be applicable to most cases of recoveries arising from judgments, but there are many exceptional cases which must be decided according to

[13] C. B. 5, page 83; O. D. 1028.

other sections of the law and according to the decisions of the courts which define taxable income.

As stated above, the fair value of a claim as of March 1, 1913,[14] is an important consideration. If a taxpayer was entitled to property in 1912, but did not recover it until 1921, it cannot be held, and the Treasury does not hold, that he received any taxable income in 1921.

If he became entitled to property in 1914, but did not return it in that year because he did not know its actual value, it is not reasonable to claim that if he collected the claim or received the property in 1921, the entire amount would be income in 1921. The courts might hold that the income arose in 1914 and give the taxpayer the privilege of filing an amended return for that year, but there is little in the trend of recent decisions to support such a belief. The courts are more likely to hold that when a taxpayer could have adopted the accrual basis of reporting, but did not do so, the election of the cash basis must stand.

As late as 1917 (see Chapter XXXI) the Treasury held that when a corporation was compelled, in 1916, to pay damages arising out of an infringement case and the period of infringement ended in 1912, no part of the sum paid was deductible as an expense in 1916, but that it should all be deducted (by amended returns) in the period prior to 1912.

Patent development costs.—The cost of developing a patent is of the same nature as carrying charges on real estate. One has the option of capitalizing the items or of charging them off as current expenses. Frequently it is difficult to determine which course should be pursued, even at the time. It may be obvious, after a period, that the experiments under way are not yielding satisfactory results. In such an event the cost is a clear expense. More often the result is doubtful, in which case it is permissible to elect whether to capitalize or to charge off the amount.

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[14] For method of establishing value at March 1, 1913, see page 592.

Conservative accounting methods call for charging off, but the owner may be penalized for so doing if current profits are not large. The subsequent sale of the patent for a considerable profit would result in a tax on the entire sale price, if previously the development costs had all been claimed as deductions and written off.

REGULATION. . . . . The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. . . . . (Art. 293.)

The foregoing regulation cannot always be applied to patent litigation. If the litigation does not clearly add to the value of the patent, the expenses should be charged off as they are incurred. This view is adopted by the Treasury in the following:

RULING. The M Company expended a certain amount in litigation defending its right, title, and interest in a patent after the patent had been issued by the Government.

Held, that this amount may be deducted as an ordinary and necessary operating expense. The actual cost of the patent represented by various Government fees, cost of drawings, experimental models, attorney's fees, etc., paid before the patent was issued, will be returned to the company through annual depreciation deductions. . . . . (C. B. 2, page 105; Digest A. R. R. 98.)

Method of valuing patents.—Owing to the great uncertainty which often exists regarding the commercial (that is, the market or income-producing) value of a patent, it is difficult to arrive at a fair taxable value when a sale or transfer is made for a consideration other than cash before the patent is fully developed.

In ascertaining the net taxable income of an inventor or owner to be assessed as of the year in which a transfer takes place, there should be taken into consideration the stage of the patent's commercial development, the degree of prosperity attained by the concern manufacturing it, and any other facts which serve to fix a fair value. Some of the information may appear to be of a later date, but it is valuable nevertheless.

The Committee overruled the findings of the Income Tax Unit in one case in which, prior to incorporation of a new company, 50 per cent of the earnings (after allowing 10 per cent on the tangibles) were ascribed to patents and 50 per cent to goodwill, trade-names, etc. The Committee increased the Unit's allowance from $60x$ dollars to $133x$ dollars. The Committee said:

RULING. It considers that a capitalization on basis of 10 per cent gives recognition to the value of the patents as indicated not only by the earnings of the companies prior to the reorganization of January, 1913, but also subsequent thereto. The Committee also has in mind the emphasis which was placed on the value of the patents when the two predecessor companies were in litigation. The Committee can not, however, ignore the fact that the trade names used on the patents of the predecessor companies had a good-will or trade-mark value. (C. B. I-1, page 374; A. R. R. 799.)

Value of patents March 1, 1913.—Under the 1917 law[15] patents were included among tangible assets for the purpose of determining invested capital. Under the 1918 law[16] and also under the 1921 law for the one year that the excess profits tax was still in force, patents were included among intangible assets. Generally speaking the rules for valuing tangible and intangible property, heretofore discussed, govern the valuation of patents. The distinctive features which exist in regard to patents will now be discussed.

Values of patents must be established (a) to arrive at the basis for the computation of depreciation allowable as a deduction from gross income, and (b) for the purpose of reporting gains or losses resulting from their sale or disposition.

REGULATION. A taxpayer disposing of patents or copyrights by sale should determine the profit or loss arising therefrom by computing the difference between the selling price and the cost. The taxable income in the case of patents or copyrights acquired prior to March 1, 1913, should be ascertained in accordance with the provisions of article 1561. The profit or loss thus ascertained should be increased or decreased, as the case may be, by the amounts deducted on account of

[15] Section 207 (a-3-a).
[16] Section 325 (a).

depreciation of such patents or copyrights since February 28, 1913, or since the date of acquisition if subsequent thereto. . . . . (Art. 40.)

A patent is valuable for a limited period. It can never be treated as of permanent value *per se*. Rights and privileges permanent in their nature may develop from patents, but such rights should not be classified as patents. The monopoly granted by the government is for a specific period. Patents, therefore, come within the category of depreciable assets. At times it is difficult to distinguish between patents and goodwill.[17] Except for the year 1917 (when patents were classified as tangibles), the only difference of importance between patents and goodwill is the element of depreciation.

Under the Treasury regulations a deduction for depreciation of patents is made at the election of the taxpayer. It is not obligatory. However, if depreciation has been taken the amounts so deducted must be considered, when patents are sold or disposed of, in the same manner as in the sale of tangible assets.[18]

Depreciation is such an important element that the correct valuation of patents as at March 1, 1913, may make a material difference in the amount of taxes payable after January 1, 1917. Prior to that date the rate of tax was so low that it made little difference how much was claimed for depreciation of patents. Taxpayers who practically disregarded patent values and depreciation of patents prior to 1917, are not barred from reopening their accounts and tax returns and making proper adjustments.[19] The mere failure to assert one's rights does not operate as a waiver.[20] The Commissioner has no power to enforce any regulation or rule which limits the right of a taxpayer to correct his tax returns for previous

[17] See article 843.
[18] Art. 843.
[19] For table of terms of patents and copyrights in various countries, see C. B. 3, page 169; O. D. 721.
[20] ". . . . Mere delay in asserting a right does not ipso facto bar its enforcement in equity, by the great weight of authority, unless the case is barred by the statute of limitations." (21 C. J. 221.)

years, except only in case of fraud. It has not been, and cannot be, urged that the opening of tax returns arising from properly supported revaluations can be considered fraudulent.

To determine the actual value of patents at March 1, 1913, is in many cases a difficult task. Each case must be decided on its own merits. There existed at that date instances in which taxpayers had in the dim past merged patents and other intangibles such as goodwill, in their accounts. In other instances a number of patents were acquired without a value being placed on each distinct patent. Intercompany book transactions also frequently tended to render the value of patents obscure. Numerous other complications exist. Nevertheless, in order that the taxpayers' interests may be protected and in order that the government may receive the proper amount of tax, patent values must be established. When the amounts involved are large, it is a problem upon which expert assistance should be employed.

Patents acquired subsequent to March 1, 1913, and later disposed of, do not differ from other assets in so far as the method of treatment for the purpose of determining gain or loss on the transaction is concerned.[21]

If patents were acquired solely for cash prior to March 1, 1913, and if the payments can be readily traced through the accounts, the tax laws presume that the cash payments represent the actual value of the patents at the time acquired. Unless the purchase was made immediately before March 1, 1913, the cash payment would not be an important factor in fixing the value as of that date.

If the consideration for the patents was stocks, bonds or notes which had a marketable value at the time of acquisition, it is presumed by the Treasury that the value of the patents was equal to the market value of the securities received therefor. If the securities were not marketable but were in the nature of investment securities having a fixed rate of return, their appraisal is usually a comparatively simple matter.

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[21] See Chapter XXII.

Cases have arisen in which the nominal value of stock issued for patents was considerably less than the known cash value. Such cases occur when, for some particular reason, it is desired to keep the capitalization of the purchasing corporation at a low figure. If the corporation subsequently sells the patent and the taxable profit on the sale were based on the nominal value of the stock, substantial injustice would be done to the seller to whom an excessive profit would be imputed. The taxable profit must be based on the real cash value as of the time of acquisition, little or no attention being paid to the nominal value of stock issued for the patents. The foregoing applies particularly to common stock which usually receives the greatest benefit from a successful patent.

Actual value may be determined by earnings, past and prospective, which are attributable to the ownership of patents. If it can be shown that, after providing for a return on the net tangible assets, the excess is due to the ownership of patents, such excess earnings may be used in fixing the value of the patents.

The following article sets forth various factors which should be considered in valuing intangibles paid in for stock. The same principles would also apply to a valuation as of March 1, 1913.

Regulation. The actual cash value of intangible property paid in for stock or shares must be determined in the light of the facts in each case. Among the factors to be considered are (*a*) the earnings attributable to such intangible assets while in the hands of the predecessor owner; (*b*) the earnings of the corporation attributable to the intangible assets after the date of their acquisition; (*c*) representative sales of the stock of the corporation at or about the date of the acquisition of the intangible assets; and (*d*) any cash offers for the purchase of the business, including the intangible property, at or about the time of its acquisition. A corporation claiming a value for intangible property paid in for stock or shares should file with its return a full statement of the facts relating to such valuation. . . . . (Art. 851.)

The regulation very properly permits the use of earnings both prior and subsequent to the date of acquisition. The

Committee has held, however, that a valuation for patents or other intangibles cannot be supported solely by subsequent earnings.[22]

Ralph H. Allen, Assistant Financial Executive of the Thomas A. Edison Industries, with the assistance of Walter A. Staub, C. P. A., of Lybrand, Ross Bros. & Montgomery, has published an interesting article on "Patent Valuation as Affected by Federal Taxation."[23] This article not only discusses various methods which may be used in making a valuation, but it is of particular value in that it suggests several methods of segregating a gross valuation, determined under the regulations of the Treasury, to individual patents.

Royalties paid by licensees are another factor to be considered in establishing patent valuations. Royalty agreements and schedules of receipts therefrom are valuable supporting evidence.

Furthermore, the value in many cases may be demonstrated by the opinions of those who, by reason of their technical knowledge and experience, are familiar with the value of the patents in question. This method of valuation meets with the approval of the Treasury.

> RULING. . . . . Where there is no established market to serve as a guide the question of value, even of tangible assets, is one largely of judgment and opinion, and the same thing is even more true of intangible assets, ... (C. B. 2, page 31; A. R. M. 34.)

In rare cases the value of patents can be established by sales of the particular patents at or about March 1, 1913. It is obvious that the value cannot be established by sales of similar property, because we are dealing with a monopoly. The law does not attempt to limit the 1913 value to its "market" price at that time. Section 202 (a) reads "the fair market price or value of such property." There is no possibility, in 99 out of 100 cases, of ascertaining a "market price" as at March 1, 1913, and it is necessary to depend upon

[22] I-35-482; A. R. R. 1086.
[23] See *Administration,* Vol. IV, page 189.

other indices regarding the "value" of the patents as at that date.[24]

REGULATION. No method of determining this value (March 1, 1913) can be stated by the Department which will adequately meet all circumstances. What that value was is a question of fact to be established by any evidence which will reasonably and adequately make it appear. (Reg. 33, paragraph 63.)

In general, the Commissioner is required to adopt the standards and definitions of value which have been approved by the United States Supreme Court. The Treasury, while not perhaps applying strict technical rules of evidence in matters of this kind, necessarily receives and gives the same weight to evidence admissible in court as would be accorded to such evidence by a court. It therefore becomes important to consider what attitude the courts take with respect to the establishment of value of property having no precise market value. The courts not only permit, but require, that persons should be brought before the court who, from their technical experience and knowledge, are better qualified to form a judgment concerning the real value of such property than is the ordinary citizen; they require such person to detail his experience and means of knowledge to the jury, and then they permit him to express his opinion as to the actual value of the property in question, based upon his knowledge of that property in particular and upon his experience in general. The following decisions bear upon this subject:

DECISIONS. This question of damages, under the rule given in the statute, is always attended with difficulty and embarrassment both to the court and jury. There being no established patent or license fee in the case, in order to get a fair measure of damages, or even an approximation to it, general evidence must necessarily be resorted to. And what evidence could be more appropriate and pertinent than that of the utility and advantage of the invention over the old modes or devices that had been used for working out similar results? With a knowledge of these benefits to the persons who have used the invention, and the extent of the use by the infringer, a jury will be in possession of material and controlling facts that

[24] Art. 1561. See page 564.

may enable them, in the exercise of a sound judgment, to ascertain the damages, or, in other words, the loss to the patentee or owner, by the piracy, instead of the purchase of the use of the invention. (*Suffolk Co. v. Hayden,* 3 Wall. 315, 70 U. S. 315, 18 L. Ed. 76.)

There remains for consideration but a single point—that there was admitted in evidence on the trial the opinions of witnesses as to the value of the land, which were not based upon the sale of the same or similar property, and were not, therefore, the opinions of persons competent to so testify. It appears that the land taken was a strip running through a mining claim, which had been patented and belonged to the defendants in error. . . . . And yet, uncertain and speculative as it is, such "prospect" has a market value; and the absence of certainty is not a matter of which the railroad company can take advantage, when it seeks to enforce a sale. Contiguous to a valuable mine, with indications that the vein within such mine extends into this claim, the railroad company may not plead the uncertainty in respect to such extension as a ground for refusing to pay the full value which it has acquired in the market by reason of its surroundings and possibilities. In respect to such value, the opinions of witnesses familiar with the territory and its surroundings are competent. At best, evidence of value is largely a matter of opinion, especially as to real estate. True, in large cities, where articles of personal property are subject to frequent sales, and where market quotations are daily published, the value of such personal property can ordinarily be determined with accuracy; but even there, where real estate in lots is frequently sold, where prices are generally known, where the possibility of rental and other circumstances affecting values are readily ascertainable, common experience discloses that witnesses the most competent often widely differ as to the value of any particular lot; and there is no fixed or certain standard by which the real value can be ascertained. The jury is compelled to reach its conclusion by comparison of various estimates. Much more so is this true when the effort is to ascertain the value of real estate in the country, where sales are few, and where the elements which enter into and determine the value are so varied in character. And this uncertainty increases as we go out into the newer portions of our land, where settlements are recent and values formative and speculative. Here, as elsewhere, we are driven to ask the opinions of those having superior knowledge in respect thereto. It is not questioned by the counsel for plaintiff in error that the general rule is that value may be proved by the opinion of any witness who possesses sufficient knowledge on the subject; but their contention is, that the witnesses permitted to testify had no such sufficient knowledge. It is difficult to lay down any exact rule in respect to the amount of knowledge a witness must possess; and the determination of this matter rests largely in the discretion

of the trial judge. Stillwell Manufacturing Co. v. Phelps, 130 U. S., 520; Lawrence v. Boston, 119 Mass., 126; Chandler v. Jamaica Pond Aqueduct Corporation, 125 Mass., 544. The witnesses whose testimony is complained of, all testified that they knew the land and its surroundings; and many of them that they had dealt in mining claims situated in the district, and had opinions as to the value of the property. It is true, some of them did not claim to be familiar with sales of other property in the immediate vicinity; and the want of that means of knowledge is the specific objection made in the Supreme Court of the Territory to the competency of those witnesses. But the possession of that means of knowledge is not essential. It has often been held that farmers living in the vicinity of a farm whose value is in question, may testify as to its value although no sales have been made to their knowledge of that or similar property. Indeed, if the rule were as stringent as contended, no value could be established in a community until there had been sales of the property in question, or similar property. After a witness has testified that he knows the property and its value, he may be called upon to state such value. The means and extent of his information, and therefore the worth of his opinion, may be developed at length on cross-examination. And it is fully open to the adverse party, if not satisfied with the values thus given, to call witnesses in the extent of whose knowledge and the weight of whose opinions it has confidence. (*Montana Railway Co. v. Warren,* 137 U. S. 348, 34 L. Ed. 681.)

Inventions are of all sorts, and it is very difficult for a jury to estimate the value of the use of any invention either before or after the issue of letters patent. We are of opinion that, in the discretion of the court, a witness with the qualifications shown in this case might be permitted to give an opinion of the value of the use of inventions relating to stock and cattle cars. Sturgis v. Knapp, 33 Vt., 486, 531; Butler v. Mehrling, 15 Ill., 488; Brady v. Brady, 8 Allen, 101; Vandine v. Burpee, 13 Metc. (Mass.), 288; Beale v. City of Boston, 166 Mass., 53, 56, 43 N. E., 1029. (*Burton v. Burton Stock Car Co.,* 50 N. E. Rep. 1029, 1031, 171 Mass. 437.)

Where there is no evidence to show that any license fee has ever been paid or demanded, the jury, in estimating the damages, should consider the utility and advantage to the defendant of the use of the patented device, as compared with any other means of obtaining similar results whose use was open to it, and may compare the cost of using the one to the cost and saving in the use of the other. (Syllabus, *Brickill et al. v. Mayor, etc., of Baltimore,* 60 Fed. 98, 8 C. C. A. 500.)

In the case last cited, the Circuit Court of Appeals for the Fourth Circuit approved the following charge to the jury:

This is an action at law for the damages sustained by the plaintiffs for the alleged infringement, and in such actions, when there has been proved an established royalty or license fee, which has been customarily paid to the owner of the patent by those who desired to use it, such regular price for a license is the primary and true criterion of the plaintiff's damage; but in this case there is no evidence of any license fee ever having been demanded or paid by any one; and so, if you find in favor of the plaintiffs, you should consider the utility and advantage to the defendant of the use of the patented device, as compared to any other means of obtaining similar results which were open to the defendant to use, and you may consider the cost of using one as compared with the cost and savings to the defendant of using the other; and from these data, if proven to you, you should ascertain, in the exercise of a sound judgment, what would be a fair compensation to the plaintiffs for the damage which they have sustained by reason of the defendant having infringed, instead of having purchased the right to use, the invention.

Ruling. The Committee has considered the question of providing some practical formula for determining value as of March 1, 1913, or of any other date, which might be considered as applying to intangible assets, but finds itself unable to lay down any specific rule of guidance for determining the value of intangibles which would be applicable in all cases and under all circumstances. Where there is no established market to serve as a guide the question of value, even of tangible assets, is one largely of judgment and opinion, and the same thing is even more true of intangible assets such as good will, trade-mark, trade brands, etc. . . . . (C. B. 2, page 31; A. R. M. 34.)

Also see cases cited in discussion regarding fair value of services, Chapter XXXI.

Patents not issued March 1, 1913, may be valued.—The Committee has recently decided that a patent application has "no rights in the nature of property."

Ruling. . . . . The M Company was organized under the laws of the State of Y in 190—, with an authorized capital stock of $25x$ dollars, for the purpose of taking over the going businesses of the N Company and O Company, which companies were engaged in the manufacture of machinery, equipment, and supplies. Thirteen and three-tenths x dollars of the capital stock of the new company was issued for the assets of the N Company and $7x$ dollars for the assets of the O Company. Among the assets acquired were patents and good will, which, on the books of the first-named company, were valued at $9.88x$

dollars and on the books of the second-named company were valued at $2.07x$ dollars, or a total book value of $11.95x$ dollars, which amount was set up on the books of the new company. The revenue agent states that subsequent to the acquisition of the original patents and prior to 1917 other patents were acquired by the company at a cost to it of $1.58x$ dollars, so that on December 31, 1916, the total of the patent and good will account was $13.53x$ dollars, and this amount has been allowed in the computation of invested capital.

At December 31, 1916, the company owned 33 patents, 3 of which were among those acquired at the date of organization and not expired, 26 developed by the company and issued to it prior to March 1, 1913, and 4 developed by the company and issued subsequent to March 1, 1913. The last 4 patents are by far the most important and the representatives of the company earnestly urge that the mere fact that the patents were not actually issued until after March 1, 1913, should not preclude the company from a depreciation deduction on the property right existing in the inventions on March 1, 1913. Elaborate schedules purporting to show the actual earnings from these patents from 1913 to 1920, inclusive, have been submitted. Without pointing out the gross errors in the computations submitted, or commenting on the use of earnings subsequent to March 1, 1913, to establish a fair market value as of that date, it is only necessary to determine whether the deductions claimed for depreciation of this property right are allowable. The regulations provide that in computing a depreciation allowance in the case of a patent the total sum to be replaced is the cost of the patent or its fair market value as at March 1, 1913. The patent is the depreciable asset. The four patents in question did not exist on March 1, 1913. There is no property right in a patent application which would be protected by the courts and therefore no asset on which a depreciation deduction is allowable under the law or the regulations. The courts have repeatedly held that the application for a patent confers no rights in the nature of property and that it is not until letters patent are granted that the patentee or his assignee acquires an exclusive property in the patented invention. Thus in *Gaylor v. Wilder* (10 How. 477, page 493), the court stated:

> The inventor of a new and useful improvement certainly has no exclusive right to it unless he obtains a patent. This right is created by the patent, and no suit can be maintained by the inventor against anyone for using it before the patent is issued.

Again, in *Brill v. St. Louis Car Company* (80 Fed., page 910):

> An inventor has no exclusive right to his invention at common law, but derives all such exclusive right from the grant of the Government, subject to the provisions of the statutes conferring the right. These statutes limit the monopoly to the term of 17 years from the date of the grant as evidenced by the patent. Manifestly, therefore,

there can be no invasion of the patentee's rights by any manufacture or use of the device, the subject matter of an expected patent, prior to the date of the patent.

Also in *McCormick v. Aultman* (169 U. S., page 608):

It has been settled by repeated decisions of this court that when a patent has received the signature of the Secretary of the Interior, countersigned by the Commissioner of Patents, and has had affixed to it the seal of the Patent Office . . . . it has become the property of the patentee and as such is entitled to the same legal protection as other property.

On the above authorities it is therefore recommended that no deduction for depreciation based on a fair market value as at March 1, 1913, of the four patents for which application had been made but which were issued subsequent to March 1, 1913, be allowed, inasmuch as no property or property right, a proper subject of depreciation, existed on that date. Such property right was not created and did not exist until the letters patent were issued. The allowable deduction for depreciation of these four patents is therefore limited to the cost thereof. . . . . (I-35-482; A. R. R. 1086.)

The Committee cites three cases in support of its position, none of which is applicable. In the first case, *Gayler v. Wilder*,[25] an inventor had assigned his application for a patent. The patent was issued to the assignee who brought this suit for infringement. The defense was that the assignee had no title. Mr. Chief Justice Taney said:

. . . . The discoverer of a new and useful improvement is vested by law with an inchoate right to its exclusive use, which he may perfect and make absolute by proceeding in the manner which the law requires, ...

The thing to be assigned is not the mere parchment on which the grant is written. It is the monopoly which the grant confers; the right of property which it creates. And when the party has acquired an inchoate right to it, and the power to make that right perfect and absolute at his pleasure, the assignment of his whole interest, whether executed before or after the patent issued, is equally within the provisions of the act of Congress.

The Act provided that every patent shall be assignable in law.

The second case, *Brill v. St. Louis Car Co., et al.*,[26] merely

[25] 10 How. 477, 18 Curtis 466, 51 U. S. 477, 13 L. Ed. 504.
[26] 80 Fed. 909.

decides that a patentee may not sue for infringements committed prior to the issuance of the patent. It does not decide that patent applications are not property. In a later case,[27] it was held that although infringements committed during the pendency of an application do not form the basis of a suit for damages, the articles made and used by the infringer may not be used or sold legally after the patent issues. Thus an application is valuable property if for no other reason than that the applicant may, as soon as his patent is issued, prevent the use or sale of articles covered by his patent by others even though such use began prior to the issuance of the patent.

The third case, *McCormick Harvesting Machine Co. v. Aultman Company,*[28] does not involve an application at all. The court merely held that a patent, once issued, could not be revoked by the Patent Office.

That a patent application does vest property rights in the applicant is clearly indicated by the case of *De La Vergne Refrigerating Machine Company v. Featherstone,*[29] decided by the Supreme Court of the United States in 1893. An inventor applied for a patent and died a short time thereafter. He had assigned a one-half interest in the patent to an associate. The court held that the patent when issued was the joint property of his administratrix and the assignee. If, then, the rights incident to a patent application are of such a nature as to pass to the administrators and assigns of the applicant upon his death, they are surely property within the accepted legal meaning of that term.

In the recent case of *Keystone Type Foundry v. Fastpress Co.,*[30] District Judge Learned Hand, after citing as his authority *Gayler v. Wilder,* said:

> It must be taken as law that an inventor has property which he may assign prior to patent, at least when application is pending and the patent is specifically described.[31]

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[27] *Columbia & Nehalem River Railroad Co. v. Chandler,* 241 Fed. 261.
[28] 169 U. S. 606, 42 L. Ed. 875.
[29] 147 U. S. 209, 37 L. Ed. 138.
[30] 263 Fed. 99.
[31] This case was overruled on other grounds in 272 Fed. 242.

It has been repeatedly held that a patent application may be assigned. In a carefully prepared opinion reviewing the authorities, Judge Haight in the case of *Individual Drinking Cup Co. v. Osmun-Cook Co.,*[32] held that an assignment executed pending application, passes the full legal and equitable title of the assignor to the assignee.

If, then, an application for a patent, pending March 1, 1913, was property capable of assignment, the value on that date should be the basis for computing deductions for depreciation.

A. R. R. 1086 is contrary to an earlier decision[33] of the Committee wherein a patent application is treated as property for invested capital purposes.

Applications are assigned perhaps daily. In many instances, large royalties are received. If an application is not property, such royalties are not taxable income according to the United States Supreme Court's definition of income in the *Macomber* case:[34] "Income may be defined as the gain derived from capital, from labor, or from both combined." Clearly the royalties cannot be derived from labor. If the application is not property, the royalties are not income.

Depreciation of patents.—The method of depreciation, when a patent was not issued until after March 1, 1913, necessarily differs from that applicable to patents issued prior to March 1, 1913. For a discussion of this point, see Chapter XXXVI.

Royalties subject to depreciation charges.—The following ruling explains the extent to which royalties subject to depreciation charges are taxable.[35]

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[32] 220 Fed. 335.
[33] C. B. 3, page 342; A. R. R. 328.
[34] *Eisner v. Macomber,* 252 U. S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521.
[35] See Chapter XXXVI for a full discussion of the depreciation of patents.

Ruling. A invented certain apparatus and secured United States patents thereon. The patents were assigned to a foreign corporation under an agreement by which he retained 40 per cent interest in profits therefrom. Legal title to the patents passed to the company subject to the agreement mentioned. A's interest was recognized by the company and by the United States licensees under the patents. The committee is of the opinion that the agreement should be recognized as giving A a depreciable interest in the patents.

The value of each patent as at March 1, 1913, should be segregated and the depreciation allowable thereon determined on the basis of its own life instead of using as a basis the average life of all the patents and the value of all the patents in bulk. Of the total depreciation allowable for any year, 60 per cent is deductible in the return of the company and 40 per cent in A's return. (C. B. 2, page 142; A. R. M. 35.)

INCOME FROM INTEREST—GENERAL

All interest, except on state, municipal and certain United States securities, is to be included in gross income, whether on notes, bank deposits, bonds, mortgages or deeds of trust or other similar obligations of domestic corporations and insurance companies, bonds issued in foreign countries or upon foreign mortgages or like obligations (even though not payable in the United States).

Interest on tax-exempt securities is not to be reported as a part of gross income. The statement showing the number and amount of such securities and the income therefrom, which was required to be submitted with the annual income tax return[1] under the 1918 law, is not required under the 1921 law.

Subject to the exceptions stated, not only is all interest received by residents and domestic corporations taxable, but interest received by non-resident aliens and foreign corporations from sources within this country[2] is also taxable—a fact which raises an interesting question of international double taxation.[3]

The law and procedure regarding interest derived from United States obligations, including Farm Loan bonds, will be found in the following chapter. Interest from all other sources is discussed in this chapter.

Interest subject to tax.—

LAW. Section 213. **That for the purposes of this title . . . . the term "gross income"—**

(a) Includes gains, profits, and income derived from . . . . interest . . . .

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[1] Prior to 1918, interest which was entirely exempt from taxation did not have to be reported at all.

[2] As defined in section 217 (a-1) of the 1921 law. See Chapter XLI.

[3] For discussion of the principles involved in the taxation of non-resident aliens, see Chapter XLI.

In order to exclude all exempt interest from taxation, taxpayers, particularly banks and other financial institutions, should keep separate ledger accounts for interest from various sources.

Interest due but not collected.—

REGULATION. When interest coupons have matured, and are payable, but have not been cashed, such interest payment, though not collected when due and payable, is nevertheless available to the taxpayer and should therefore be included in his gross income for the year during which the coupons matured. This is true if the coupons are exchanged for other property instead of eventually being cashed. Defaulted coupons are income for the year in which paid. . . . . (Art. 53.)

Owners of bonds should not accrue the interest until there is a reasonable chance of collecting it. Of course, if the taxpayer could collect, but does not, there is no excuse for not reporting the amount accrued.

ACCRUED INTEREST RETURNED AS INCOME WHICH IS NOT SUBSEQUENTLY COLLECTED.—Taxpayers reporting upon the accrual basis should report as taxable income accruals from bonds, real estate mortgages, loans and other obligations when there is a reasonable expectation that such interest will be received in due course. In cases where it develops that the debtor is unable to pay the interest previously entered as income, this interest should be charged off on the taxpayer's books as a bad debt as soon as it is known to be worthless.[4]

In a ruling under the 1918 law, published in February, 1922, the Treasury held that a taxpayer could not be permitted to change from an accrual to a cash basis in accounting for interest when such interest was in part uncollectible, but must seek relief by charging off such items as bad debts.[5]

[4] [Former Procedure] Where interest on loans made by a parent corporation to its subsidiary accrued from year to year, but was not paid, the amount thus accrued during a taxable year cannot be considered income to the parent company within the meaning of the Act of August 5, 1909. (T. D. 3133, dated February 25, 1921.)

[5] C. B. I-1, page 52; A. R. R. 737. See Chapter XXXV.

Interest accrued prior to March 1, 1913, not taxable.[6]—The regulations provide that interest which accrued on or before March 1, 1913, and was subsequently collected, is not taxable.[7]

REGULATION. Any claim existing unconditionally on March 1, 1913, whether presently payable or not and held by a taxpayer prior to March 1, 1913, whether evidenced by writing or not, and all interest which had accrued thereon before that date, do not constitute taxable income, although actually recovered or received subsequent to such date. Interest accruing on or after that date is taxable income. Where an interest-bearing claim held on February 28, 1913, is paid in whole or in part after that date, any gain derived from the payment of the claim is taxable. The amount of such gain is the excess of the proceeds of the claim (both principal and interest) exclusive of any interest accrued since February 28, 1913, already returned as income, over the cost thereof (both principal and interest then accrued). However, the gain to be included in gross income where the fair market value of the claim as of March 1, 1913, is greater than the cost thereof, is the excess of the amount received over such value. No gain results where the amount received from the claim is more than the cost thereof but less than its fair market value as of March 1, 1913. . . . . (Art. 90.)

Interest on obligations of states and political subdivisions.—It will be recalled that the law exempts interest upon "the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia." [Section 213 (b-4).] For a full discussion, including the definition of "political subdivision," see page 381 *et seq.*

INTEREST ON SUCH OBLIGATIONS SOLD BETWEEN INTEREST DATES.—

RULING. When interest-bearing obligations of a State or political subdivision thereof are sold between interest dates and the agreement

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[6] [Former Procedure] The action of the Income Tax Unit in holding that an item of interest "which accrued prior to March 1, 1913, constituted taxable income in 1915, the year in which received," was reversed on appeal. (C. B. 4, page 102; A. R. R. 375.) See also *Plant v. Walsh, Collector*, District Court of the United States, District of Connecticut, 280 Fed. 722 (decided April 12, 1922).

In a case under the 1909 law, it was finally held that interest accrued prior to 1909 and paid in 1911 was not taxable. (C. B. 3, page 243; T. D. 3048.)

[7] See Chapter XXVII.

of sale specifies a division between the price of the obligation and the accrued interest, the interest which is advanced by the vendor to the vendee is interest on the obligations of a State and is exempt from tax. . . . . (C. B. I-1, page 27; I. T. 1187.)

INCOME FROM SALE OR REDEMPTION OF SUCH OBLIGATIONS ISSUED AT A DISCOUNT—WHEN TAXABLE.—

RULING. . . . . If the obligations, whether interest bearing or non-interest bearing, were issued at a discount, any excess of the selling price over the cost of the obligations to the vendor is a taxable profit to the extent of such excess, even though the agreement of sale specifies a division between the price of the obligation and the accrued discount. . . . . (C. B. I-1, page 27; I. T. 1187.)

The foregoing ruling deals with profit on sales. When redeemed by the obligor, the difference between the redemption price and the cost to the holder (if the latter paid as much as, or more than, the original issue price) is held, in the following ruling, to be exempt income.

RULING. The M bank purchased certain 10 year 4½ per cent municipal bonds at 96.10 which had been originally issued and sold by the municipality at 94.50. The question is presented as to whether in case the bank sells the bonds before maturity at 98, the profit realized will be exempt in its hands.

Held, that inasmuch as no person other than the municipality can pay the interest borne by the obligations of the municipality (whether such interest is paid at the specified rate or in the form of realized discount) any person selling municipal bonds for an amount in excess of the cost of the bonds to him realizes a taxable profit to the extent of such excess amount even though the bonds were issued at a discount.

If, therefore, the bank sells at $98 the municipal bonds issued at $94.50 and purchased by it at $96.10, it will derive a taxable profit of $1.90 on each bond sold. If, however, it holds the bonds to maturity and receives $100 the difference between the purchase price of the bonds and the amount received, or $3.90, will represent exempt income to it. (C. B. 4, page 31; O. D. 762.)

Interest on bank deposits.[8]—

REGULATION. . . . . Interest credited on savings bank deposits,

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[8] **[Former Procedure]** Under a 1914 ruling, the Treasury sought to require taxpayers reporting on a cash basis to report accrued but unpaid interest on bank deposits. See *Income Tax Procedure*, 1922, page 667, footnote.

even though the bank nominally have a rule, seldom or never enforced, that it may require so many days' notice in advance of cashing depositors' checks, is income to the depositor when credited. (Art. 53.)

Counsel for the American Bankers Association has expressed the opinion that so-called interest on savings bank deposits are really dividends and thus exempt from the normal tax.

However, the following recent ruling seems to hold that interest on bank deposits can only be construed to be a dividend for the purpose of taxation, when the distributing bank is a mutual savings bank all of whose shareholders or members are depositors and whose capital is the aggregate of the deposits of its members or shareholders.

RULING. Interest received on a deposit in a mutual savings bank not having capital stock represented by shares is not a dividend within the statutory definition thereof and the amount therefore can not be taken as a credit for normal tax purposes. (Also section 201, Art. 1541.) (I-40-537; Digest I. T. 1461.)

As to non-resident aliens see Chapter XLI.

Interest on loans to Liberty bond subscribers.—

RULING. Interest received by a bank on loans to subscribers for Liberty bonds is *not* interest received on obligations of the United States, and is therefore subject to tax. (C. B. 1, page 67; O. D. 16.)

Interest on Food Administration Grain Corporation notes.—

RULING. Interest on Food Administration Grain Corporation notes is not exempt from income and excess profits taxes. (Telegram to The Corporation Trust Company, signed by Commissioner Roper, April 13, 1919.)

Interest charged to construction.—

RULING. No taxable income accrues to a public utility corporation from a mere book entry charging construction account and crediting income account due to charging interest on the company's own funds used temporarily for construction purposes, as permitted under the Interstate Commerce Commission's classification; neither

will the company be allowed to include in its assets such amount of interest charged to capital account for the purpose of determining invested capital. (C. B. 1, page 212; O. D. 246.)

By O. D. 1061 (C. B. 5, page 206) this ruling was extended to apply to the Revenue Acts of 1916 and 1917.

Income from bonds paid at maturity or before.—When bonds are purchased at a discount from their face value or when they are purchased at par and paid off at a premium, the excess received above cost or value March 1, 1913, (and interest periodically collected) is taxable income. If held for more than two years the benefit of the capital gains tax on the excess (exclusive of the interest) may be secured.[9]

RULING. Interest received or accrued on bonds purchased at a premium, according to the method employed in keeping books, represents income for the year in which received or accrued at the rate carried by the bonds and not at the rate which would be realized after amortizing the premium.[10] (C. B. 3, page 89; O. D. 622.)

It may be expected that non-interest bearing notes and bonds will become popular. Taxpayers in receipt of large incomes loaning money for more than two years, will be able to buy the obligations at a discount and report their gross returns thereon as capital gains.

Income from redemption of bonds—amortization of premium.—The following regulation summarizes the cases in which income is deemed to arise upon the redemption by a corporation of its own bonds or from the amortization of the premium on its bonds sold above par.

REGULATION. (1) (*a*) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. . . . . (*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.

(2) (*a*) If bonds are issued by a corporation at a premium, the

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[9] See Chapter XXII.
[10] See Chapter XXXII.

net amount of such premium is gain or income which should be prorated or amortized over the life of the bonds. . . . . (*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price minus any amount of premium already returned as income, the excess of the issuing price minus any amount of premium already returned as income (or of the face value plus any amount of premium not yet returned as income) over the purchase price is gain or income for the taxable year.

(3) (*a*) If bonds are issued by a corporation at a discount, [and] . . . . (*c*) If, however, the corporation purchases and retires any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted) over the purchase price is gain or income for the taxable year. (Art. 545.)

The subject of deductible loss because of the purchase and retirement by a corporation of its bonds is discussed in Chapter XXXIV.

Interest received by stock-brokers and others.—Interest charged by stock-brokers and others, who in the ordinary course of business make regular interest entries against customers' accounts, should be reported in income tax returns at the gross amount so accrued or collected, and not at the net amount ascertained by deducting interest paid. Under the 1917 and prior laws, reporting the net amount was held to be illegal.[11]

Sinking fund increment.—Before 1918, because of the interest limitation,[12] some importance attached to the question as to whether interest on a corporation's own bonds held in its own sinking fund should be reported as income. At present the question is of no moment.

Regulation. If a corporation, in order solely to secure the payment of its bonds or other indebtedness, places property in trust, or sets

[11] This point was decided in the case of *Altheimer & Rawlings Investment Co. v. Allen, Collector* (248 Fed. 688, 160 C. C. A. 588; certiorari denied, 248 U. S. 578, 63 L. Ed. 430, 39 Sup. Ct. 20.

[12] [Former Procedure] For criticisms of regulations under former laws, see *Income Tax Procedure*, 1920, page 407.

aside certain amounts in a sinking fund under the control of a trustee, who may be authorized to invest and reinvest such sums from time to time, the property or fund thus set aside by the corporation and held by the trustee is an asset of the corporation, and any gain arising therefrom is income of the corporation and shall be included as such in its annual return. The trustee, however, is not taxable as such on account of the property or fund so held. (Art. 542.)

Income from building and loan associations.[13]—

REGULATION. . . . . An amount credited to shareholders of a building and loan association, when such credit passes without restriction to the shareholder, has a taxable status as income for the year of the credit. Where the amount of such accumulations does not become available to the shareholder until the maturity of a share, the amount of any share in excess of the aggregate amount paid in by the shareholder is income for the year of the maturity of the share. (Art. 53.)

RULING. . . . . If the subscription was made prior to March 1, 1913, and under the rules of the association the share subscribed for had a cash surrender value on March 1, 1913, and any year thereafter in excess of the amount paid in by the shareholder, the determination of any profit realized at the time of cash surrender or for the year of the maturity of the share will be based on the proceeds in excess of the cash surrender value as of March 1, 1913, plus the aggregate amount paid in subsequent thereto. (C. B. 2, page 87; O. D. 446.)

Shares in many building and loan associations are not of the same nature as shares in corporations. No dividends are declared, but earnings are ascertained and are fully apportioned *pro rata* to the outstanding stock. So far as the books of the associations are concerned, an actual distribution is made and no surplus account is carried.

The accruing annual income from building and loan association shares is almost entirely interest, the element of economic profit being almost altogether absent.

The funds are invested largely in bonds and mortgages. The organizations themselves are exempt from the income tax, and being mutual in character, each stockholder is in

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[13] [Former Procedure] For prior regulations see *Income Tax Procedure*, 1921, pages 511-512.

effect realizing annually his pro rata share of the entire net income. It would therefore appear that in the case of stock subscribed for prior to March 1, 1913, the fair value at that date was the book value of such stock and not the surrender value.

EXEMPTION OF $300.—

LAW. Section 213. . . . . (b) . . . . (10) **So much of the amount received by an individual after December 31, 1921, and before January 1, 1927, as dividends or interest from domestic building and loan associations, operated exclusively for the purpose of making loans to members, as does not exceed $300; . . . .**

Although a literal interpretation of this provision might indicate that the maximum limit for the period, 1922-1926, is $300, the author believes that the Treasury has carried out the intention of Congress[14] in ruling that as much as $300 is exempt for each of the four years.

REGULATION. . . . . (2) So much of the amount received by an individual after December 31, 1921, and before January 1, 1927, as dividends or interest from domestic building and loan associations operated exclusively for the purpose of making loans to members as does not exceed $300 per year; . . . . (Art. 89.)

A distinction is made by the Treasury[15] between dividends from building and loan associations under section 231 (4), "*substantially* all the business of which is confined to making loans to members," and those under section 213 (b-10) which are "operated *exclusively* for the purpose of making loans to members." Dividends from the former are exempt from normal tax under section 216 (a). Those from the latter, to the extent of $300 per year, are not included in gross income at all. They may not, however, be credited under section 216 (a).

Interest on securities acquired between interest dates.— When securities are purchased between interest dates and

[14] For a full statement of the legislative history of this provision, see *Income Tax Procedure,* 1922, pages 671-672.
[15] I-29-413; I. T. 1394.

the buyer pays to the seller an amount equal to the accrued interest between the last interest date and the date of sale, each should enter as income the portion of the interest assignable to the period during which he owned the security.

Ruling. Interest accrued on bonds and other interest-bearing obligations sold between interest dates is income as such to the vendor when the agreement of sale specifies a division between the price of the obligation and the accrued interest.

The vendee of such securities may exclude from interest income a sum equal to the amounts advanced by him to the vendor on account of accrued interest.

Capital gain or loss resulting from a sale of interest-bearing obligations sold between dates at a stipulated price plus accrued interest is computed upon a basis of capital investment, and without regard to amounts paid or received on account of accrued interest.

The burden is on the taxpayer to show what part of moneys paid or received by him on account of a transaction involving the sale or purchase between interest dates of interest-bearing obligations should be allocated to capital investment and what part to accrued interest. In the absence of such showing the construction most favorable to the Government should be adopted. . . . . (C. B. 3, page 90; Digest Sol. Op. 46.)[16]

Interest received by legatee.—T. D. 2570 (November 6, 1917) held that:

Ruling. A legatee is required to return as income the full amount of interest received by him on a bond, notwithstanding the fact that a part of the first coupon, payable after he had received it, had been added to the bond and included in the gross estate of the decedent, thereby becoming subject to the estate tax law.

If the estate was assessed for the inheritance tax on the accrued interest to the date of the death of the decedent, the legatee should not pay income tax on the same amount, since property received by legatees is capital and includes accrued interest. The 1917 regulation is unsound and probably will not now be enforced.

Income from life insurance policies.—The law exempts from income taxation[17] the entire proceeds of life insurance

[16] See page 665 as to rulings on municipal bonds.

[17] The taxability of the proceeds of life insurance under the estate tax law is discussed in Chapter XLV.

policies (see page 373) upon the death of the assured, whether paid to individual beneficiaries, to the estate of the assured, or to a corporation or partnership beneficiary.[18] The total amount paid in premiums may be less than the amount eventually received from the proceeds of a policy, but the difference is not treated as taxable income. The law[19] expressly limits the exemption. When there is a return of principal to the assured during his life, that part, if any, of such return which is in excess of the premiums paid is taxable. The basis of this provision is that the amount received in excess of the premiums paid represents interest on the premiums.

The purpose of the law in mentioning the exemption from taxation of premiums returned or the equivalent of premiums returned evidently was to leave no doubt about the matter. When premiums are paid they do not in this country[20] constitute an allowable deduction, but are treated as capital payments. Therefore, the return of all or any part of such capital can not properly be taxed under an income tax law. However, the law covers the point, even if unnecessarily, and there can be no controversy about it. If the assured receives at the maturity of a policy on the endowment plan, or from its cancellation, any amount in excess of premiums paid, such receipts are taxable income and must be returned.[21] As provided in

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[18] **[Former Procedure]**

Regulation. Proceeds of life insurance policies payable to the estate of a decedent, when received by an executor or administrator, are, in the amount by which such proceeds exceed the premium or premiums paid by the decedent, income of the estate to be accounted for by the executor or administrator under the provisions of section 2 (b), act of September 8, 1916. (Reg. 33, 1918, Art 29.)

This regulation was based on section 2 (b) of the law. Until the question is judicially settled an estate is entitled to claim that a policy should be valued as of March 1, 1913, as a basis for taxation under the 1916 or 1917 law. Under the 1918 law insurance paid to a corporation beneficiary was taxable. For provisions of earlier laws see footnote 57 on page 373.

[19] Section 213 (b-2).

[20] For British practice, see Chapter XXXI.

[21] See "Paid-up Policies," Chapter XV.

article 47, any dividends received would be subject only to the surtaxes. (See Chapter XXVII.)

In view of the uncertainty of such income it would hardly be practicable to accrue it annually on the books of the assured. This means that the entire excess above premiums paid must be included in the return for the year of its receipt.

Regulations. . . . . In the case of an insurance policy its surrender value as of March 1, 1913, may be used as a basis for the purpose of ascertaining the gain derived from the sale or other disposition of such property. . . . . (Art. 90.)

. . . . Where an insured receives under life insurance, endowment, or annuity contracts sums in excess of the premiums paid therefor, such excess is income for the year of its receipt. . . . . Distributions on paid-up policies which are made out of earnings of the insurance company subject to tax are in the nature of corporate dividends and are income of an individual only for the purpose of the surtax. (Art. 47.)

Proceeds of a policy left with the insurance company was held to be, in effect, a loan to the company, and interest thereon taxable.[22]

Ruling. The basis for ascertaining the taxable income resulting from the disposition of a life insurance policy acquired prior to March 1, 1913, where the insured transfers the policy to some one other than the insurance company, which wrote the policy, is the cash surrender value of the policy as at March 1, 1913. However, if the insured surrenders his policy and all his rights thereunder to the insurance company, which wrote the policy, the aggregate amount of the premiums paid during the period the policy was held, or the cash surrender value of the policy as at March 1, 1913, whichever is greater in amount, is to be taken as the basis in computing the taxable income derived by the insured. (C. B. 2, page 77; O. D. 379.)

Annuities.—

Regulation. Annuities paid by religious, charitable, and educational corporations under an annuity contract are subject to tax to the extent that the aggregate amount of the payments to the annuitant exceeds any amounts paid by him as consideration for the contract. An annuity charged upon devised land is income taxable to the annuitant, whether paid by the devisee out of the rents of the land or from other sources. The devisee is not required to return as tax-

[22] C. B. 3, page 120; O. D. 612.

able income the amount of rent paid to the annuitant, and he is not entitled to deduct from his taxable income any sums paid to the annuitant. . . . . (Art. 47.)

Many annuities are gifts. In such cases this ruling strictly interpreted would not apply. The amounts received by the beneficiary would be taxable income only to the extent of the excess of the aggregate receipts above the capital value of the annuity at the date of the gift.

RULINGS. An individual who receives income from an annuity which has been purchased for his benefit by another person is not liable for tax thereon until the payments received under the terms of the annuity have equaled the amount paid or set aside to purchase or establish same. (C. B. 1, page 76; O. D. 170.)

Under the terms of an agreement entered into in the State of New York between a religious corporation and an individual, whereby securities are transferred to the corporation in consideration of the payment to the individual for life of such income as the corporation should receive on such securities not exceeding a certain per cent per annum on the face value thereof, the corporation did not become the absolute owner of the securities but the donor retains a life interest therein and a trust was created. The income from such securities prior to the sale thereof does not constitute an annuity but is income arising from a trust taxable to the beneficiary. (C. B. I-1, page 79; I. T. 1220.)

In the same situation the income from the religious corporation after the sale was held to constitute payment of an annuity subject to tax to the extent that the aggregate amount of such payments exceeded the fair market value of the securities at the time of their conversion into cash.[23]

As to the deductibility of payments made in connection with annuity contracts, see Chapter XXXII.

Tax-free covenant bonds—tax paid at source not additional interest.—It has been a common custom for corporations to issue bonds containing a covenant binding the corporation to pay the interest free of all taxes which it may be required to

[23] C. B. I-1, page 79; I. T. 1363.

withhold at the source.[24] The 1921 law provides that the recipient of income from securities containing a tax-free covenant does not include in gross income the tax of 2 per cent paid by the obligor (payer of the income).

LAW. Section 234. (a) . . . . (3) . . . . **In the case of obligors specified in sub-division (b) of section 221[25] no deduction for the**

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[24] [Former Procedure]. The 1913 law, by establishing the system of collection at the source, threw upon such corporations the burden of paying the normal tax applicable to the interest payable to their bondholders. The rate under this law was 1 per cent. The requirement was continued under the 1916 law, which raised the rate to 2 per cent.

1916 LAW. Section 5. . . . . . (c) For the purpose of the normal tax only, the income embraced in a personal return shall be credited with . . . . the amount of income, the normal tax upon which has been paid or withheld for payment at the source of the income under the provisions of this title.

In 1917, when the system of collection at source was almost completely abandoned and the rates of the normal tax were increased to 4 per cent on individuals and 6 per cent on corporations, collection at the source was retained to the extent of 2 per cent only in the case of these tax-free covenant bonds. In the 1918 law the same provision is made.

1918 LAW. Section 221. . . . (d) Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.

Under the 1918 law, the recipient of income from securities having a tax-free covenant was required to include in gross income not only the income actually received, but also the tax paid by the obligor, which the Treasury held was constructively received. Ever since the issue of the second edition of Reg. 45 (April, 1919), the author has contended that the tax of 2 per cent paid by the obligor was not income of the obligee. That the author was justified in his criticism that the rulings and regulations did not carry out the intention of Congress, is indicated by the fact that Congress has inserted a definite provision covering the point in the 1921 law. For a full discussion see *Income Tax Procedure*, 1921, pages 516-522.

The Treasury's position has been upheld in a decision by the United States District Court for the Eastern District of Pennsylvania (*Massey v. Lederer, Collector*, 277 Fed. 123). In that case, however, the court did not have presented to it and did not consider what the author considers to be the chief factor, viz., the attempt of Congress to make the deduction effective by permitting it to be deducted from the amount of tax payable. Such action precludes the inference that it should be dealt with as constructive income.

[25] See Chapter XIV.

payment of the tax imposed by this title, or any other tax paid pursuant to the contract or provision referred to in that subdivision, shall be allowed, nor shall such tax be included in the gross income of the obligee. . . . .

Section 221 (d) still permits the tax paid by the obligor to be used as an offset to the tax due from the recipient as shown by his return.[26]

Interest from foreign subsidiaries.—

RULING. A domestic corporation owning a majority of the stock of foreign corporations should include in its income tax return any amounts of interest debited to its foreign subsidiaries, but it may claim as a deduction any amount of interest credited to such subsidiaries. . . . . (C. B. 1, page 239; O. D. 330.)

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[26] For credit where tax-free covenant bonds are sold between interest dates, see Chapter XXXIII.

CHAPTER XXV

INCOME FROM INTEREST ON OBLIGATIONS OF THE UNITED STATES

(Including Interest on Bonds Issued Under the Federal Farm Loan Act and on Bonds of the War Finance Corporation)

Three broad statements can be made regarding interest received upon obligations of the United States and obligations issued under the Federal Farm Loan Act of July 17, 1916, and the War Finance Corporation Act, approved April 5, 1918:

1. Such interest received by corporations after January 1, 1922, is wholly exempt;[1]
2. No part of such interest received by individuals is subject to normal income tax; and
3. Such interest is subject to surtaxes[2] only in the case of obligations issued after September 1, 1917, and as to these, only so far as such interest is not exempt under provisions of the several Liberty Bond Acts and other acts under which these obligations are issued.[3]

By authority of one of these acts, interest from the 3¾ per cent Victory notes, although issued after September 1, 1917 (redeemed during 1922), was not subject to any surtax. All the interest from Farm Loan bonds is wholly tax-exempt.

Interest which is wholly exempt from tax is excluded from "gross income" as defined in the 1921 law. If the income of a

[1] C. B. I-1, page 99; I. T. 1244.

[2] All Liberty bonds are subject to the estate tax. See Chapter XLV.

[3] Non-resident individuals and partnerships not engaged in business in the United States are not subject to surtax on Liberty bond interest. See page 689.

taxpayer is wholly from exempt sources, or if his net income from other sources is less than $1,000 (single) or $2,000 (married or head of a family), he need not make an income tax return unless his gross income (excluding that from exempt sources) exceeds $5,000.[4]

Law. Section 213. That for the purposes of this title . . . . the term "gross income"— . . . .

(b) Does not include the following items, which shall be exempt from taxation under this title:

(4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit), and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt to the taxpayer from income, war-profits and excess-profits taxes; . . . .

Interest wholly exempt.—The obligations, interest upon which is wholly exempt for all taxpayers, are:

1. The following bonds, certificates, and notes issued under the Liberty Bond Acts and all United States obligations issued before September 1, 1917:[5]
   (a) The 3½ per cent First Liberty bonds, original issue, unconverted.
   (b) The 3¾ per cent Victory Loan notes issued under the Victory Liberty Loan Act, approved March 3, 1919. (These bonds were redeemed during 1922.)
   (c) Postal Savings deposits.[6]

[4] See page 92.

[5] Includes bonds issued under the First Liberty Bond Act, approved April 24, 1917. Certificates of indebtedness issued under this act were also exempt.

[6] [Former Procedure] Only the interest credited on postal savings deposits prior to September 1, 1917, was exempt (Reg. 45, Art. 77). The 1918 law did not specifically exempt the interest from postal savings certificates of deposit as does the 1921 law [section 213 (b-4-c)].

2. Obligations issued under the Federal Farm Loan Act of July 17, 1916.[7]

Interest in no part exempt from surtax.—The interest on 4¾ Victory Loan notes is subject to surtax.

About $870,000,000 of the 4¾ per cent Victory notes have been called for redemption December 15, 1922, and according to their terms,[8] the remaining $930,000,000 of the same issue will mature on May 20, 1923.

Treasury notes issued under the Victory Liberty Loan Act are essentially different from Treasury certificates and are placed in the same class with Victory 4¾'s in so far as relates to exemption; in other words, there is no exemption from surtax for interest from Treasury notes.

Interest subject to special exemption.[9]—The special exemptions applicable under the 1921 law are described in the law and regulations as follows:

LAW. Section 1328. . . . . (a) On and after January 1, 1921, 4 per centum and 4¼ per centum Liberty bonds shall be exempt from graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, now or hereafter imposed by the United States upon the income or profits of individuals, partnerships, corporations, or associations, in respect to the interest on aggregate principal amounts thereof as follows:

Until the expiration of two years after the date of the termination of the war between the United States and the German Government, as fixed by proclamation of the President, on $125,000 aggregate principal amount; and for three years more on $50,000 aggregate principal amount.

(b) The exemptions provided in subdivision (a) shall be in addition to the exemptions provided in section 7 of the Second Liberty Bond Act, and in addition to the exemption provided in subdivision (3) of section 1 of the Supplement to the Second Liberty Bond Act in respect to bonds issued upon conversion of 3½ per centum bonds, but

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[7] The constitutionality of these obligations was affirmed by the U. S. Supreme Court in *Smith v. Kansas City Title & Trust Co. et al.*, February 28, 1921; 225 U. S. 180, 41 Sup. Ct. 243, 65 L. Ed. 577.

[8] Letter of Secretary Mellon, dated October 9, 1922.

[9] [Former Procedure] For details as to procedure under the 1918 law, see *Income Tax Procedure*, 1921, page 524 *et seq.*

shall be in lieu of the exemptions provided and free from the conditions and limitations imposed in subdivisions (1) and (2) of section 1 of the Supplement to Second Liberty Bond Act and in section 2 of the Victory Liberty Loan Act.

REGULATION. . . . . (3) 4 per cent and 4¼ per cent Liberty bonds (but not 4¾ per cent Victory notes), Treasury certificates of indebtedness, and Treasury (war) savings certificates are entitled to certain limited exemptions from surtaxes and excess-profits taxes now or hereafter imposed by the United States. . . . . For the period from January 1, 1921, to July 2, 1923, the total possible exemption from surtaxes and profits taxes amounts to $160,000, while for the period from July 3, 1923, to July 2, 1926, the total possible exemption amounts to $55,000, as follows:

Period Jan. 1, 1921, to July 2, 1923:

$5,000 in the aggregate of first 4s, first 4¼s, first second 4¼s, second 4s and 4¼s, third 4¼s, fourth 4¼s, Treasury certificates of indebtedness, and Treasury (war) savings certificates.[10]

30,000 of first second 4¼s.

125,000 in the aggregate of first 4s, first 4¼s, first second 4¼s, second 4s and 4¼s, third 4¼s, and fourth 4¼s.

$160,000 total possible exemptions for this period.

Period July 3, 1923, to July 2, 1926:

$5,000 in the aggregate of first 4s, first 4¼s, first second 4¼s, second 4s and 4¼s, third 4¼s, fourth 4¼s, Treasury certificates of indebtedness, and Treasury (war) savings certificates.[10]

50,000 in the aggregate of first 4s, first 4¼s, first second 4¼s, second 4s and 4¼s, third 4¼s, and fourth 4¼s.

$55,000 total possible exemptions for this period. (Art. 83.)

The changes were effective as of January 1, 1921. Interest received before that date was subject to the provisions of the 1918 law.

Certain exemptions not limited as to time.—There are only two exemptions which are unlimited as to the time they remain in force: (1) interest on $5,000 of the Second, Third, and Fourth[12] Liberty Loans; and 4¼ per cent Treasury bonds of 1947-52; and (2) interest on $5,000 of bonds of the War

[10] To which should now be added 4¼ per cent Treasury bonds of 1947-52, issued October 15, 1922.

[11] *Ibid.*

[12] This $5,000 exemption applies also to certificates of indebtedness and War Savings and Treasury Savings certificates, and War Savings Stamps.

Finance Corporation. These two exemptions are entirely separate and a single taxpayer may have the benefit of both.

$155,000 additional exempt until 1923.—To simplify the computation of tax-exempt interest, the 1921 law[13] consolidated, and to some extent liberalized, the various exemptions granted under the several Liberty Bond Acts. July 2, 1921, having been officially proclaimed as the date of the termination of the war with Germany, the exemption periods referred to in section 1328 (a) expire on July 2, 1923, and on July 2, 1926, respectively. Therefore, in addition to the $5,000 exemptions referred to in the preceding paragraph, the interest on $125,000 principal in 4 or 4¼ per cent Liberty bonds and on $30,000 of first second 4¼'s is exempt until July 2, 1923.

$50,000 additional exempt 1923-1926.—After July 2, 1923, interest on $50,000 principal in Liberty bonds of any issue bearing interest at 4 or 4¼ per cent is exempt for a further period of three years, i. e., until July 2, 1926. This exemption is also in addition to the $5,000 exemptions already referred to.

Interest on savings certificates—how accounted for.—

Ruling. . . . . In the case of a taxpayer reporting income on a basis of cash receipts and disbursements, the difference between the issue price of the Savings certificates and the amount received upon their redemption is deemed to be income to the holder in the taxable year when received. The amount thus received is exempt from all State and local taxation (except estate and inheritance taxes) and from the normal Federal income tax and the corporation income tax. It is not exempt from graduated additional income taxes, commonly known as surtaxes, nor from excess-profits and war-profits taxes, except to the extent that it falls within the above-described exemption in respect of the interest on an aggregate principal amount of 4 and 4¼ per cent Liberty bonds, Treasury certificates of indebtedness and Savings certificates, not exceeding $5,000. For the purpose of com-

[13] Section 1328. See page 680.

puting this limited exemption, Savings certificates are to be taken at issue price, and if the exemption is claimed with respect to any holdings of Savings certificates it will be deemed to cover the period during which the taxpayer holds the Savings certificates in respect to which the exemption is claimed, and not merely the taxable year in which the certificates are redeemed. In other words, if the taxpayer holds and claims exemption upon $4,000 (issue price) of Savings certificates of the Series of 1922, for the full period of 5 years to maturity, he will not be able to claim any exemption with respect to any other holdings in excess of $1,000 of Liberty bonds, Treasury certificates of indebtedness or Savings certificates under the $5,000 limited exemption above described, for any part of the 5-year period. If, on the other hand, the holder of $4,000 (issue price) of Savings certificates, Series of 1922, has during the prior four years taken the full benefit of the $5,000 limited exemption with respect to other holdings of bonds or certificates, he will not be able to claim exemption in the fifth year for more than the amount by which the maturity value of the Savings certificates exceeds the published redemption price at the beginning of that year.

In the case of a taxpayer reporting on an accrual basis, the interest to be reported for each year is the excess of the published redemption price of the certificates at the end of his accounting year, or of the amount received upon redemption, if redeemed during the year, over the corresponding published price for the beginning of that year; and the interest exempt from taxation, if any, is the proportion of the interest accrued that the portion of the issue price includable in the exemption for each year is of the total issue price. . . . . (C. B. I-1, page 100; T. D. 3301.)

Interest accrued upon conversion of Victory notes.[14]—

Regulation. All interest accrued on 4¾ per cent Victory notes at the date of any conversion by the taxpayer into 3¾ per cent Victory notes shall, for the purpose of computing net income, be deemed to be interest upon 4¾ per cent Victory notes, and subject to surtaxes and excess-profits and war-profits taxes, now or hereafter imposed by the United States upon the income or profits of individuals, partnerships, associations, or corporations. Any and all amounts received by any taxpayer from the United States by way of adjustment of accrued interest upon the conversion of 4¾ per cent Victory notes into 3¾ per cent Victory notes shall be deemed to be interest upon 4¾ per cent Victory notes.

All interest accrued on 3¾ per cent Victory notes at date of any conversion by the taxpayer into 4¾ per cent Victory notes shall, for

[14]For procedure on conversion of other issues of Liberty bonds, see *Income Tax Procedure,* 1921, page 540.

the purpose of computing net income, be deemed to be interest upon 3¾ per cent Victory notes and shall be entitled to the exemptions from taxation to which interest on 3¾ per cent Victory notes is entitled. (Art. 82.)

Computation when holdings are not constant.—

REGULATION. . . . . Since the basis of the exemptions is the principal amount of bonds held rather than the amount of interest received, where the holdings are not constant during the taxable period, if at any time the holdings of any issue or issues are less than the maximum exempted principal, then the exempted interest for such time shall be only the amount of interest received or accrued upon the principal actually held. (Art. 85.)

The method prescribed by the Treasury for determining the maximum exemption when the holdings vary from time to time during the year, is made clear in the following example:

4¼% Liberty bonds held for 6 months, January 1 to June 30, 1922 (par)		$200,000
6 months' interest on $200,000 at 4¼% is	$4,250	
Total maximum exemption		160,000
Principal amount in excess of exemption		$ 40,000
6 months' interest on $40,000 at 4¼% is the amount of taxable interest, viz	$ 850[15]	

RULING. The question has been raised as to whether in cases where Liberty loan bonds are sold during the year the exemption from income taxes of the interest on such bonds should be determined on the basis of the average principal held during the year, instead of on the basis of actual holdings by periods as provided in the instructions in connection with Schedule E on Form 1040 for 1921.

Held, that if a taxpayer holds Liberty loan bonds for any period in which the principal is in excess of the exemption, the interest on such excess is taxable. If there are variations in the principal held, but that principal is not in excess of the exempted principal, it is not necessary to attach a schedule showing the variation in the principal held. A statement attached to the return to the effect that the prin-

[15] **[Former Procedure]** Under the procedure previous to 1921 the total interest received ($4,250) would be capitalized at 4¼ per cent, resulting in an "average principal" of $100,000, which is less than the $160,000 of exempt principal, so that none of the interest received ($4,250) would be taxable.

cipal was never in excess of the exempted principal will be satisfactory to the Bureau. Also, on the other hand, if the principal amount held was in all cases in excess of the exempted principal, a statement to that effect will be satisfactory. But where for certain periods the amount of bonds held was less than the exempted principal and in other cases in excess of the exempted principal, the schedule called for by the return must be submitted. (C. B. I-1, page 102; Digest I. T. 1229.)

Exemptions when return is for period less than full year.—When return is made for a period less than one year, the 1921 law [section 226 (c)] provides that the net income "shall be placed on an annual basis."[16] The amount of taxable interest should be first computed before the net income is placed on an annual basis, because such taxable interest is part of "net income."

Interest is income of year when due.—Under the present ruling of the Treasury all interest on bonds is income of the year when it becomes due, whether then collected or not.

Even when matured coupons have not been collected, they should, nevertheless, be included in the return. But see the author's comment on article 53 on page 664.

Coupons given away must be accounted for.—

Ruling. An owner of nontax-free Liberty bonds who has made an absolute gift of the coupons attached to the bonds covering interest due for a number of years will be required to include in his income tax return the interest which accrues each year on the bonds, and to pay any tax that may be due thereon. If the gift of the coupons is to an institution under section 214(a)-11, a deduction of such gift would be allowed in the annual income tax return. (C. B. 1, page 84; O. D. 120.)

Separate ledger accounts for interest.—The taxpayer should keep a separate ledger account for "interest received from Liberty bonds" to facilitate segregation of such parts thereof as are taxable and non-taxable, respectively. He should

[16] See page 83.

also keep a separate ledger account for "interest paid to carry tax-exempt bonds," because such interest is not deductible from gross income. This account should not include any interest paid to carry obligations of the United States issued after September 24, 1917, including the 3¾ per cent Victory notes and the 4¼ per cent Treasury bonds (if original subscriptions are by the taxpayer), because such interest is deductible.[17]

Accrual of interest on Liberty bonds.—The practice is common among business concerns to accrue other items of income and at the same time not to accrue Liberty bond interest. There is, however, no logical reason for not accruing such interest when other items of income and expense are accrued. The law requires that accounts be kept so as to reflect the actual net income of the taxpayer. The accrual method has been prescribed to accomplish this for business concerns.

If the taxpayer is to secure the maximum benefit from the exemptions, he must accrue the interest, for interest received after the expiration dates of the temporary exemptions (July 2, 1923, and July 2, 1926), if accounted for on the cash basis, does not come within the scope of the exemptions.

For manner of treating interest on bonds purchased and sold between interest dates, see page 671.

Discount on certificates of indebtedness.—The following ruling was issued under the 1918 law:

Ruling. In the case of Treasury certificates of indebtedness which are offered by the Government at par and accrued interest and not at a discount, only the coupon interest can be considered exempt from normal tax, and from surtax to the extent provided by the Act approved September 24, 1917. Where such certificates are subsequently purchased at a discount, the difference between the purchase price and the par value of the certificates received at maturity is profit subject to both normal tax and surtax. The subscriber for

[17] Sections 214 (a-2) and 234 (a-2).

Treasury certificates who sells them at a discount sustains a deductible loss, which is the difference between the par value of the certificates and the selling price. . . . . (C. B. 3, page 123; O. D. 729.)

Federal Land Bank bonds exempt.—The income from obligations issued under the Federal Farm Loan Act of July 17, 1916, is exempt from normal and surtax.

Regulation. As section 26 of the Federal Farm Loan Act of July 17, 1916, provides that every Federal land bank and every national farm loan association, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from taxation, except taxes upon real estate, and that farm loan bonds, with the income therefrom, shall be exempt from taxation, the income derived from dividends on stock of Federal land banks and national farm loan associations and from interest on such farm loan bonds is not subject to the income tax. . . . . (Art. 75.)[18]

Interest received through partnerships and trusts.—Under the law individuals are taxed as such upon their income from partnerships[19] in which they are members, and from estates and trusts of which they are beneficiaries. It is necessary, therefore, for the individual receiving Liberty bond interest from a partnership or a fiduciary, to group by issues all such interest received and to calculate his exempt interest on the basis of his combined holdings of principal as an individual, as a partner, and as a beneficiary of an estate or trust. The various regulations of the Treasury do not specify the manner in which the principal of Liberty bonds held by partnerships, estates and trusts shall be apportioned among the individuals receiving the income therefrom other than to say that each partner, etc., is to be regarded as owning a "proportionate part" of the bonds. The assignment of holdings, however, should ordinarily be made on the basis of the share in profits or income received from the partnership or fiduciary.

In case of a net loss for the year by the partnership or estate, although the individual will show his share of Liberty

[18] See Chapter XXIX.
[19] [Former Procedure] Between January 1, 1918, and December 31, 1921, personal service corporations were treated as partnerships.

bond interest received from the partnership or estate, any undue increase of the taxable income of the individual thus apparently created will, in the case of partners, but not always in the case of beneficiaries of trusts,[20] be offset by the increased share of the loss of the partnership which the individual will also show in his return.

The regulations covering exemptions of Liberty bond interest received from partnerships and fiduciaries are as follows:

REGULATION. (*a*) When income is taxable to beneficiaries, as in the case of a trust the income of which is to be distributed to the beneficiaries periodically, each beneficiary is regarded as the owner of a proportionate part of the bonds held in trust and is entitled to exemption on account of such ownership as if he owned such proportionate part of the bonds directly. When, on the other hand, income is taxable to the trustee, as in the case of a trust the income of which is accumulated for the benefit of unborn or unascertained persons, the trustee is regarded as the owner of all the bonds held in trust and the trust is entitled to exemption on account of such ownership. As to exemptions in the case of bonds beneficially owned by nonresident aliens, see article 94.[21]

(*b*) As the income of a partnership is taxable to the individual partners, each partner is treated as the owner of a proportionate part of the bonds held by the partnership and is entitled to exemption on account of such ownership as if he owned such proportionate part of the bonds directly. . . . . (Art. 84.)

Partnerships.—As explained in the preceding paragraph, since partnerships are not taxed as such, Liberty bond interest received by a partnership does not lose its identity but is taken up as such by the individual partners in their separate returns. The partnership return merely indicates the share of each partner in the Liberty bond interest received by the partnership.[22]

[20] See Chapter XLII.

[21] See Chapters XXXIV and XLII.

[22] [Former Procedure] Under the 1917 law partnerships as such were subject to the excess profits tax. T. D. 2762, dated October 21, 1918, provides that in calculating Liberty bond interest received by a partnership, which may be subject to excess profits tax, the partnership shall be deemed to be the owner of the bonds upon which the interest is received.

Fiduciaries.—Liberty bond interest received by executors, administrators, guardians, trustees, and other fiduciaries is taxable to them only in case it is not distributable to the beneficiaries of the estate or trust.[23]

If the fiduciary is liable to tax, he is entitled to the same exemptions of Liberty bond interest as an individual.

Corporations

The general statements on pages 678 to 687 in this chapter apply to interest on Liberty bonds received by corporations. The following special provisions apply to corporations only.

Exemptions of affiliated corporations.—

RULING. Each of several affiliated corporations included in a consolidated return under section 240 of the Revenue Act of 1918 is entitled to the same full benefits under the exemption provisions of the several Liberty bond acts to which it would be entitled if not affiliated. (C. B. 1, page 87; T. B. R. 7.)

Parent corporation may not apportion Liberty bond holdings to its subsidiaries.—A parent corporation may not apportion Liberty bonds held by it among the affiliated corporations. If the parent corporation should make a bona fide sale of bonds to the subsidiary corporations, then such corporations would be entitled to the exemptions consequent on the holding of the bonds purchased.

United States obligations owned by non-resident aliens,[24] etc.—In order to encourage foreign investors to buy and hold Liberty bonds, Congress provided in the Victory Liberty Loan Act that obligations of the United States shall be exempt from federal, state, and local taxes while beneficially owned by non-

[23] See Chapter XLII for discussion of the cases in which fiduciaries must make a return and pay a tax. See also article 84, quoted above.

[24] See Chapter XLI.

resident aliens and foreign corporations, partnerships and associations not engaged in business in the United States.

LAW.[25] Section 4. That section 3 of the Fourth Liberty Bond Act is hereby amended to read as follows:

"Section 3. That, notwithstanding the provisions of the Second Liberty Bond Act or of the War Finance Corporation Act or of any other Act, bonds, notes, and certificates of indebtedness of the United States and bonds of the War Finance Corporation shall, while beneficially owned by a nonresident alien individual, or a foreign corporation, partnership, or association, not engaged in business in the United States, be exempt both as to principal and interest from any and all taxation now or hereafter imposed by the United States, any State, or any of the possessions of the United States, or by any local taxing authority."

[25] Victory Liberty Loan Act, approved March 3, 1919, section 4; 40 Stat. at Large, Part 1, 1311.

CHAPTER XXVI

INCOME FROM RENTS

Under all of the income tax acts rent has been subject to taxation.

LAW. Section 213. . . . . the term "gross income"—
(a) Includes . . . . income derived from . . . . rent[1] . . . .

Income from rents may be reported on the accrual basis or on the actual receipt basis. If books of account are kept, all rents accrued, and believed to be collectible, should be reported. Any items found to be uncollectible may be deducted as losses in subsequent returns. If reporting on the accrual basis is not practicable or convenient, it is sufficient to return all rents received in cash during the tax year.

No taxable income accrues where corporations, through book entries, have charged rental to construction accounts and credited an income account.[2]

Permanent improvements by lessees.—In several decisions the courts have held that title to improvements paid for by lessees vests in lessors as soon as made.[3] Prior to these decisions the Treasury held that the lessor was taxable on the value of improvements at the end of the lease.[4] Since these decisions the Treasury holds that the lessor may be taxable at the time when the improvements are made.

The regulations give the lessor the option of reporting

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[1] Rentals from "ground rents" as existing under laws of the state of Maryland should be returned each year as rent and are subject to tax as such. (C. B. 5, page 98; O. D. 1089.)

[2] C. B. 4, page 276; O. D. 811.

[3] See page 695 *et eq.*

[4] [Former Procedure] For text of regulations in force prior to 1922 and criticism thereof, see *Income Tax Procedure,* 1920, pages 441-443, and *Income Tax Procedure,* 1921, pages 549-553.

any income derived from improvements made by the lessee either in one amount upon completion of the improvements or of spreading such income over the period of the lease.

Regulation. When buildings are erected or improvements made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor may at his option report the income therefrom upon either of the following bases:

(*a*) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease. This amount would ordinarily be the difference between the value of the land free from the lease without such improvements and the value of the land subject to the lease with such improvements.

(*b*) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the termination of the lease and report as income for each year of the lease an aliquot part thereof.

If for any other reason than a bona fide purchase from the lessee by the lessor the lease is terminated, so that the lessor comes into possession or control of the property prior to the time originally fixed for the termination of the lease, the lessor receives additional income for the year in which the lease is so terminated to the extent that the value of such buildings or improvements when he became entitled to such possession exceeds the amount already reported as income on account of the erection of such buildings or improvements. No appreciation in value due to causes other than the premature termination of the lease shall be included. Conversely, if the buildings or improvements are destroyed prior to the expiration of the lease, the lessor is entitled to deduct as a loss for the year when such destruction takes place the amount previously reported as income because of the erection of such buildings or improvements, less any salvage value subject to the lease to the extent that such loss was not compensated for by insurance. If the buildings or improvements destroyed were acquired prior to March 1, 1913, the deduction shall be based on the cost or the value subject to the lease as of that date, whichever is lower, less any salvage value subject to the lease to the extent that such loss was not compensated for by insurance. . . . . (Art. 48.)

The Treasury's interpretation of the earlier regulation illustrates the application of option (a) of the present regulation, quoted above, as follows:

Ruling. . . . . A, in 1915, leases certain land to B for 20 years. B agrees, in part consideration for the lease, to erect on the leased ground

a building, specifications agreed upon, of an estimated life of 25 years and to cost $50,000, which building is not to be subject to removal by B. The building is completed in 1920.

A realizes income in 1920, the year in which title to the building passes. The measure of the income is the present value to A of the building, of an estimated life of 25 years and cost of $50,000, the use and enjoyment of which is postponed for 15 years. The depreciated value of the building at the termination of the period of the lease will be approximately $20,000—that is, cost less depreciation sustained. The income of A, then, is the discounted value of $20,000 receivable at the end of 15 years. If market value reflects intrinsic value, this amount should equal the difference between the value of the land free from the lease without the buildings and the value of the land subject to the lease with the building. However, any other evidence available should be considered in determining this present worth to the taxpayer of the legal title to the encumbered building. Since A has included in income only the depreciated value of the building, he is entitled to a depreciation deduction with respect to such building only for the years after the termination of the period of the lease when A has come into possession. This depreciation deduction to which A is entitled for 1935 and subsequent years should be computed on a basis of the estimated remaining life of the building and a "cost" value equal to the market value placed on the encumbered building by A in the year of its erection, i. e., the annual depreciation deduction for 1935 and subsequent years will be the quotient obtained by dividing (*a*) the value of the improvements to A as determined by him when the same completed became part of the realty, by (*b*) the number of years in the estimated remaining life of the improvements from the termination of the lease.

In any case in which the term of the lease is greater than the estimated life of the improvement no income should be accounted for by the lessor at the time of the passage of title. Also if the improvements will have no value at the termination of the lease, as is often the case in mining leases, no income is realized by the lessor. (C. B. 4, page 90; Mim. 2714.)

Option (b) in Regulations 62 is a reasonable basis if it can fairly be assumed that income arises annually out of the improvements paid for by the lessee.

Unimproved land upon which lessees erect buildings rarely increases in fair market value because of the improvements. The maximum benefit which the lessor can realize during the lease is the rental reserved in the lease. The lessor will of course return the rent as gross income, but it cannot be claimed

in most cases that additional income has been realized because of the construction of improvements by the lessee.

In the illustration it is assumed that a building erected by a lessee has a life of twenty-five years. Experience proves that many buildings erected by lessees for a special purpose become obsolete within twenty-five years. If lessors are required to report upon completion income equal to the estimated present value of the building, which in the illustration would be a substantial sum, where would the cash be found to pay the tax? A building might easily be completed near the close of a taxable year. There would be no income in that year from the lessee, and the taxpayer might have no other source of income. How could it be held that he had taxable income to the extent of the present worth of a building in which he has no beneficial interest for fifteen years?

The author does not know of any such transaction which would result in taxable income. Article 48 as amended does not attempt to impute income where there is none. It merely states that the lessor may report as income: (a) "the fair market value of such building or improvement subject to the lease," or (b) the estimated depreciated value of the building or improvement prorated over the life of the lease. It leaves to the lessor the fixing of the depreciated value. There may be some appreciation in value on account of the improvements, but any apparent appreciation is decidedly limited by the terms of the lease which, it may be assumed, expressly reserves to the lessee the full benefit and enjoyment of the improvements. The lessor does not pay for the improvements and it is not intended that he should receive much, if anything, more than the stipulated annual rental. As was said by Mr. Justice Pitney in the stock dividend case:[5]

> Enrichment through increase in value of capital investment is not income in any proper meaning of the term.

In other words, there must be realization before there can be taxable income.[6]

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[5] *Eisner v. Macomber,* 252 U. S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521.
[6] See *Income Tax Procedure,* 1920, pages 441-443; 1921, pages 549-553.

In the old regulations the Treasury ignored the March 1, 1913, factor and attempted to impose income taxes upon property, which is unconstitutional. The new regulations are equally faulty in ignoring the trend of the decisions of the United States Supreme Court. It will probably be impossible to impose any income tax whatever on a lessor at the time when improvements are made, even though title vests simultaneously; but it may easily develop that at the end of a lease, when title, possession, and enjoyment merge, there may be realized and be taxable income equal to the fair market price (equivalent to cash) of the improvements.

Decisions. (Syl.) Where, in 1907, the owner of land leased the same for 23 years, under an agreement requiring the tenant to construct an expensive brick building, and on the tenant's default the owner retook possession in 1916, the value of the building cannot be deemed income accruing in the year 1917, within income tax law September 8, 1916, section 2 (a), for under the lease the title to the building vested in the owner immediately upon construction, and the lessee's default caused the owner a loss. (*Miller v. Gearin,* 258 Fed. 225, 169 C. C. A. 293; certiorari denied, 250 U. S. 667, 63 L. Ed. 1197, 40 Sup. Ct. 13.)

Plaintiff is the owner of a lot of land in the city of San Francisco, upon which, under the terms of a lease made by plaintiff in 1908 for a term of 26 years, there was erected by her tenant a class A steel and concrete building, the lease providing that "in no event shall the lessee hereunder have any right to remove any building from said premises." The building was completed in 1910. In 1916, the tenant defaulting in accrued rent, the lease was by mutual arrangement canceled and terminated, and possession of the leased premises surrendered to plaintiff.

The tax in question was assessed for the year 1916 upon the then value of the building erected under the lease, upon the theory that the structure represented "gains, profits, and income" accruing to plaintiff for that year, under an interpretative rule of the Treasury Department, made for the guidance of taxing officers, that:

"Permanent improvements under lease or rental contracts, when improvements become a part of real estate, the difference between cost of the improvements and allowable depreciation during the lease term, is gain or profit to the lessor at the end of the lease term, and is to be accounted for as income at that time." Paragraph 50, Regulations 33, Treasury Department.

The government claims that under the provisions of the act, and

this regulation made thereunder, the tax was properly assessed and collected; but I am unable to sustain this view. The right to levy the tax turns upon the question: When did the title to this building vest in plaintiff and become a part of her property for the purpose of taxation? I am of opinion that under well-settled principles, aptly expressed in section 1013, Civil Code of California, the moment the building was erected, which the terms of the lease show was to become and remain an integral part of the land upon which it was constructed, the title thereto vested as completely in the plaintiff as though constructed by the plaintiff herself. The terms of the lease clearly disclose that the erection of the building was a part of the consideration for the lease, and that it was provided for and taken into consideration in the rent reserved. It therefore became, upon its completion, a part and parcel of plaintiff's income-bearing property, and was subject to taxation in her as of that date. *City of Oakland v. Albers Bros.' Milling Co.* (Cal. App.), 184 Pac. 868.

The regulation of the Treasury Department cannot be applied to such a state of facts; if so intended, it must give way, as the department has no power to abrogate a substantive rule of law. This conclusion is not affected by the principles stated in *Board of Education v. Grant,* 118 Cal. 39, 50 Pac. 5; or *San Francisco v. McGinn,* 67 Cal. 110, 7 Pac. 187, relied on by defendant. Nor do the considerations urged by defendant as arising from the relation of landlord and tenant, between plaintiff and her lessee, apply to the terms of the lease here involved.

It results that whatever accession of value resulted to plaintiff's property from the erection of the building in question accrued and became vested in her in 1910, and not upon the termination of the lease. As this was prior to the enactment under which the tax was levied, the case falls by analogy within the principles of *Doyle v. Mitchell Brothers Co.,* 247 U. S. 179, 38 Sup. Ct. 467, 62 L. Ed. 1054; and *Hays v. Gauley Mountain Coal Co.,* 247 U. S. 189, 38 Sup. Ct. 470, 62 L. Ed. 1061. Those cases dealt with the act imposing a corporation excise tax, but, like the present act, the tax was imposed on income, and not upon capital invested, or property as such, and it was held that increase in the value of property invested, accruing before the act took effect, could not be taken into account or treated as income not realized upon until after that fact. (*Cryan v. Wardell,* 263 Fed. 248.)

Guaranteed dividends or interest as rental equivalent.— It frequently happens that where one corporation leases the property of another corporation the lessee pays as rental a sum equal to the interest on certain securities or equal to a

fixed dividend upon the capital stock of the lessor. The rental paid is a business expense of the lessee corporation and a rental income of the lessor corporation. The latter must so report the income even though the guaranteed dividends or the interest are paid directly to its stockholders.

The following regulation and ruling summarize the present procedure:

Regulation. Where a corporation has leased its property in consideration that the lessee shall pay in lieu of other rental an amount equivalent to a certain rate of dividend on the lessor's capital stock or the interest on the lessor's outstanding indebtedness, together with taxes, insurance, or other fixed charges, such payments shall be considered rental payments and shall be returned by the lessor corporation as income, notwithstanding the fact that the dividends and interest are paid by the lessee directly to the stockholders and bondholders of the lessor. The fact that a corporation has conveyed or let its property and has parted with its management and control, or has ceased to engage in the business for which it was originally organized, will not relieve it from liability to the tax. While the payments made by the lessee directly to the bondholders or stockholders of the lessor are rentals as to both the lessee and lessor (rentals paid in one case and rentals received in the other), to the bondholders and the stockholders such amounts are interest and dividend payments received as from the lessor and as such shall be accounted for in their returns. (Art. 547.)[7]

Ruling. A lessee corporation which owns a large part of the stock of the lessor corporation paid the annual rental of $50x$ dollars not directly to the lessor but as dividends to the stockholders of the lessor, retaining that part of the rental to which as a stockholder it was itself entitled. It is held that the lessor is required to include in its gross income for each of the years 1916, 1917, and 1918 the full annual rental of $50x$ dollars. (C. B. 5, page 205; Digest A. R. R. 589.)

The procedure as outlined above is prescribed even in cases where special types of securities are issued in lieu of the capital stock of the lessor corporation.

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[7] The decision upon which these regulations are based is in the case of *Rensselaer & Saratoga Railroad Company v. Irwin, Collector* (District Court, N. D., New York), March 5, 1917, 239 Fed. 739, decided under the Act of October 3, 1913; affirmed 249 Fed. 726, 161 C. C. A. 636; writ of certiorari denied by Supreme Court, 246 U. S. 671, 38 Sup. Ct. 424, 62 L. Ed. 517.

Regulation. Stock trust certificates or leased line certificates, as the case may be, issued by the lessee for the purpose of securing or holding control of the stock of the lessor are held to be issued in lieu of the certificates of capital stock, and for the purpose of this tax will be treated as capital stock and the amounts received by the holders of these certificates are dividends to the holders, to be treated as rentals by both lessee and lessor and constitute an allowable deduction in the one case and an item of income in the other, accordingly as they are paid and received.[8] (Reg. 33, 1918, Art. 104.)

These regulations have a perceptible effect upon the amount of the tax collected by the Treasury when, as under the present law, there is a difference between the rate applied to corporations and the normal tax applied to individuals.[9]

Expenditures by lessees for taxes.—Many leases between landlords and tenants stipulate that the latter shall pay taxes or make necessary repairs. Expenditures of this character are considered a part of the rent and must be reported by the landlord.[10]

Regulation. . . . . Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. . . . . (Art. 109.)

Since the net income of the owner is the same whether or not the taxes paid are included as income, many owners do not report as called for by the regulation because they have no personal knowledge of the amount of taxes paid.

Decision. A rental contract entered into in 1896 contained the provision that the lessee should pay, among other things:

"One-third of all taxes or assessments, special or otherwise, and public charges of every kind and nature that shall or may be taxed

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[8] *Ibid.*

[9] *Ibid.*

[10] [Former Procedure] Under the law as it stood prior to October 3, 1917, it was incumbent upon tenants in certain circumstances to withhold the normal tax upon rentals paid. In such cases questions sometimes arose concerning the interpretation of agreements binding tenants to pay taxes in addition to a stipulated cash rental, the landlords insisting that income taxes so withheld should be assumed by the tenant, and the tenants contending that they should be deducted from the stipulated cash rental agreed upon.

or assessed against the (lessor) or its property during the aforesaid term of years."

The question at issue was whether the federal income tax and the federal capital stock tax were to be deemed embraced in the contract and to be an obligation of the lessee. The court, approaching the question from the standpoint of the circumstances surrounding the parties, in an endeavor to interpret the intent, considered that the fact that the taxes in question were not in force when the contract was made was a pertinent circumstance and one which had led the courts in other jurisdictions to limit the meaning to be given to the taxes mentioned in the contract.

It passed to the consideration of cases where an income tax was itself involved, concluding that none of them could be held to require the payment of such a tax, and hence it held here that no such obligation was found to be in the contract nor was it necessarily or even reasonably to be implied from the language used.

The same reasoning was applied to the consideration of the federal capital stock tax or excise tax, which was also held to be beyond the contemplation of the parties.

The court therefore held that the lessor was not entitled to recover upon either item of its claim for reimbursement for the taxes paid by it. (*Des Moines Union Ry. Co. v. Chicago Great Western Ry. Co.* 177 N. W. 90.)[11]

Rent received other than in cash.—An owner of property must return for taxation all income therefrom, whether received in cash or the equivalent of cash. Many farms are leased under agreements which provide that the lessor shall receive as rental a certain portion of the crops. The lessor must return for taxation the fair value, less all expenses incurred, of the commodities received if consumed or disposed of by gift, and must return the net proceeds if sold for cash.

Houses, etc., occupied by rent-free tenants.—It may be that neither cash nor produce is collected from the occupants of houses, farms, etc., but its equivalent is realized by the owner in a different form.[12] A taxpayer may own a garage large enough to accommodate the family of a chauffeur. The wages paid to the chauffeur in such a case will usually be less than if he were obliged to live elsewhere and

[11] *Bulletin of The National Tax Association,* Vol. VI, page 51.
[12] See page 433.

pay rent. Since the saving in wages is a direct reduction of personal or living expenses, there should be returned for taxation by the chauffeur an amount equal to the saving. The same rule applies to tenants' houses on farms and country places.

As heretofore stated, the rental value of a taxpayer's residence, when occupied by himself, is not taxable, but it cannot be assumed that such exemption extends to other residences which are occupied by employees whose services are not of a gainful nature. Should not the decrease in the expenses of the employer be deemed to be constructive income?

Under the 1921 Revenue Act, the rental value of a dwelling house furnished to a minister of the gospel as part of his compensation is not to be included in taxable income.[13]

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[13] Section 213 (b-11).

CHAPTER XXVII

INCOME FROM DIVIDENDS

The taxation of dividends is complicated by the fundamental fact that the income tax is primarily a personal tax, the rate imposed upon the net earnings of corporations being, in fact although not in form, a device primarily designed for collecting part of individual shareholder's tax at the time the corporation earns the money rather than when it distributes it in dividends. Dividends, consequently, come into the hands of shareholders with a part of their tax obligation already met. This necessitates a troublesome adjustment to give proper credit to the shareholder. Other difficulties arise from the necessity of determining whether dividends represent distributions of surplus accumulated before or after March 1, 1913,[1] and from the desire to prevent the corporation from being used to avoid the payment of surtaxes.[2] The various uncertainties which have surrounded the taxation of dividends are rapidly being settled through legislation and court decisions.[3]

Dividends are taxable.—

Law. Section 213. **That for the purposes of this title . . . . the term "gross income"—**

(a) Includes gains, profits, and income derived from . . . . dividends. . . . .

Certain dividends are relieved from normal tax.—

Law. Section 216. [Individuals].[4] **That for the purpose of the normal tax only there shall be allowed the following credits:**

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[1] See page 712.

[2] See Chapter XL, "Tax on Undistributed Profits."

[3] In view of many unsettled cases relating to returns going back to 1913, it is deemed necessary to include in this chapter copious references to past regulations and decisions. For full details, however, the reader is referred to *Income Tax Procedure*, 1918, 1919, 1921 and 1922 editions.

[4] Section 234 (a-6) uses practically identical language for the similar deduction allowed corporations.

(a) The amount received as dividends (1) from a domestic corporation other than a corporation entitled to the benefits of section 262, and other than a corporation organized under the China Trade Act, 1922,[5] or (2) from a foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of section 217;[6] . . . .

It is clear that the law declines to exempt dividends from the normal tax when they are received from corporations which derive most of their income from sources within United States possessions, from corporations organized under the China Trade Act, or from foreign corporations 50 per cent or more of whose gross income for the preceding three-year period is from sources *without* the United States.[7]

"Dividend" Defined

Law. Section 201. (a) That the term "dividend" when used in this title (except in paragraph (10) of subdivision (a) of section 234[8] and paragraph (4) of subdivision (a) of section 245[9] means any distribution made by a corporation to its shareholders or members, whether in cash or in other property, out of its earnings or profits accumulated

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[5] The phrase reading "and other than a corporation organized under the China Trade Act, 1922," was added by the China Trade Act, approved by the President, September 19, 1922.

[6] See page 709 for discussion of reason for limitation of credit.

[7] [Former Procedure] Under the 1909 excise tax law corporations were not subject to tax upon dividends received. Under the 1913 and 1916 laws they were taxed. Under the 1917 law they were taxed 2 per cent when out of 1916 or 1917 earnings and 1 per cent when out of 1913, 1914 or 1915 earnings, and exempt as to the 4 per cent war income tax. The 1918 law relieved corporations from any tax on dividends received from other corporations which were themselves taxable under the federal income tax law.

Corporation income tax rates were as follows: 1913, 1914, 1915, 1 per cent; 1916, 2 per cent; 1917, 2 per cent and 4 per cent war income tax; 1918, 12 per cent; 1919, 1920 and 1921, 10 per cent.

Dividends from corporations taxed upon their net income in Porto Rico and the Philippine Islands were not allowed as credits, free of tax, in an individual return and were not allowed as a deduction in arriving at net income in a corporation return. (1918 law, section 261.)

[8] Refers to distributions by insurance companies (other than life).

[9] Refers to distributions by life insurance companies.

since February 28, 1913, except a distribution made by a personal service corporation out of earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922.[10] . . . .

Regulation. Dividends for the purpose of the statute comprise any distribution in the ordinary course of business, even though extraordinary in amount, made by a domestic or foreign corporation to its shareholders out of its earnings or profits accumulated since February 28, 1913. . . . . The term "dividends" does not, however, include a distribution made by a personal service corporation out of earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922. . . . . (Art. 1541.)

It should be noted particularly that the regulation just quoted insists that the distribution shall have been made "in the ordinary course of business." The phrase evidently is meant to distinguish such dividends from liquidation or dividends extraordinary.[11]

Ruling. Inquiry is made regarding the income tax liability of depositors in the M Savings Bank on interest paid to them on their deposits in the bank. Evidently the bank is a mutual savings bank having no capital stock represented by shares and accordingly exempt from income tax under the provisions of section 231 (2) of the Revenue Act of 1921 and the corresponding provisions of earlier statutes. . . . .

This savings bank was organized under a special law of the State of New York, which created certain individuals and their successors "a body corporate and politic, by the name of the M Savings Bank . . . ." The special law termed these individuals trustees, or managers, and provided that all vacancies in such membership should be filled by cooption. The depositors in this bank are in no way shareholders or members of the corporation. Clearly the only members of the corporation are the trustees. Although a relation of trust and confidence exists between the trustees and the depositors, the primary relationship between the bank and each of its depositors is that of debtor and creditor. (*People v. Barker,* 40 N. Y. Suppl., 1001.) Decisions of the courts of one or two States go so far as to hold that the relationship of a depositor to his savings bank is analogous to that of a stockholder of a bank of discount, but even these few decisions do not go so far as to hold that depositors are stockholders or members of a banking corporation.

This credit granted by section 216 is in effect an exemption from

[10] [Former Procedure] The 1918 definition included stock dividends and did not define the period of the personal service corporation.

[11] See page 740.

tax and should be strictly construed, and moreover is clearly limited by the definition of dividend contained in section 201.

The interest here in question is not paid to shareholders or members of a corporation and therefore does not come within this definition of dividend. The most that can be said is that this interest has some of the characteristics of dividends.

It is held, therefore, that for income tax purposes the interest on deposits in the M Savings Bank is subject to both normal and surtax in the hands of depositors. (I-40-537; I. T. 1461.)

What constitutes a distribution?—The law applies the doctrine of "constructive receipt"[12] to dividends.

LAW. Section 201. . . . . **(e) For the purposes of this Act, a taxable distribution made by a corporation to its shareholders or members shall be included in the gross income of the distributees as of the date when the cash or other property is unqualifiedly made subject to their demands.**[13]

Few stockholders in ordinary corporations have information as to when dividends are declared. Their records show only the receipts of dividends, even when accounts are kept on an accrual basis. It would be difficult for a taxpayer keeping accounts on a cash basis to make the necessary adjustments at the beginning and end of each year. Such stockholders who report dividends as of date of receipt will ordinarily be complying with the law because that is usually the date when the funds are "unqualifiedly made subject to their demands."

In the case of close corporations, however, the individual accounts of stockholders may be treated as bank accounts and it is reasonable to charge such stockholders with notice as to the dates when dividends are credited.

DECISION. . . . . It appears that in the year 1916 the earnings of the company were distributed to the stockholders by crediting them with their pro rata shares thereof upon the books of the corporation. This dividend was not, however, actually segregated from the general assets of the company.

It is well settled that the declaration of a dividend creates a debt from the corporation to the stockholders. If the amount of

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[12] See page 405.

[13] Article 1541 repeats substantially this section of the law.

the dividend be segregated and set apart from the other corporate assets in money or securities or other property, then the same becomes a trust fund, for the benefit of the stockholders, respectively. But that does not seem to have been done in this case. Therefore, the crediting of the pro rata shares of the plaintiffs, Godfrey F. Park and Susan R. Park, of this amount to their respective accounts upon the books of the company merely evidenced the indebtedness of the company to them, and did not constitute the receipt of income by them. Income means actual cash or its equivalent received, as opposed to contemplated revenue due or unpaid. *Maryland Casualty Co. v. U. S.*, 52 Ct. Cls. 201, 209 (affirmed 251 U. S. 342, 345).

Although the dividends were not income simply because credits to the extent thereof had been created, yet when the plaintiffs subsequently drew, as they did, against those credits and obtained the money thereon, then they did become income. . . . .[14]

In the foregoing case the court was satisfied that certain stockholders could not be charged with the constructive receipt of their dividends, even though credited to their individual accounts in the books. Under the 1921 law such dividends would be taxable unless the company could not pay the amounts credited.[15]

Ruling. A dividend declared by the M Company from its undivided profits was used by agreement of the stockholders for the purpose of paying in the capital stock of the O Company. The stock of the M Company was called in and canceled and new certificates issued to each stockholder in the same amount he formerly owned, in addition to shares of stock in the O Company equivalent to one-third of his holdings in the M Company. A dividend was never issued to the stockholders but was represented in one check in favor of a trustee acting as attorney in fact for all of the stockholders.

Held, that in effect an actual cash dividend was declared by the M Company. (C. B. I-1, page 12; Digest I. T. 1336.)

May a dividend be rescinded by directors or returned by stockholders?—It sometimes happens that a dividend is declared on the strength of book or paper profits and subse-

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[14] *Park v. Gilligan, Collector*, U. S. Dist. Ct., So. Dist. of Ohio, West. Div., June 11, 1921 (not reported); see Corp. Tr. Co. 1922 *Income Tax Service*, § 1261 *et seq.*

[15] **[Former Procedure]** Under the 1918 law the Treasury imposed by interpretation substantially the rule now incorporated in the 1921 law. See *Income Tax Procedure*, 1922, page 708, footnote.

quently it becomes necessary or desirable to reverse the action and arrange to secure a return of the funds paid out or credited to the accounts of stockholders.

If a single stockholder objects to the rescinding, after the formal declaration of a dividend is communicated to him or after the dividend has been credited, no legal remedy is available to compel action on his part. If, however, the dividend has been paid out of capital, the so-called dividend is not taxable at all to the stockholders and the directors may be required to reimburse the corporation to the extent to which the dividend was illegal.[16]

Ruling. A dividend declared and paid by a corporation was in part illegal, inasmuch as it exceeded the true earnings, and the corporation later rescinded it. To the extent that the corporation had a legal right to force rescission and repayment of such dividend, and such rescission and repayment were actually made, the rescinded dividend should not be considered income to the stockholders for the purpose of taxation. (C. B. 1, page 26; Digest T. B. M. 77.)

But if every stockholder consents to a rescission the case is entirely different. If directors pay a dividend which proves to be unwise, or excessive or illegal, and every stockholder agrees to return the amounts paid or credited, it may be expected that no court will hold that the payments represent income when received and capital payments when refunded, even though the dividends were paid or credited during one taxable year and the refunds occurred during the next year.

If the entire transaction occurred during the same taxable year it would not even appear in the returns or accounts of the taxpayer. In effect it would be a transaction marked "void." Therefore, when one part of the transaction occurs very late in one taxable year and the other part in the next taxable year a taxpayer should not be penalized thereby.

This has not always been the view of the Treasury.

Ruling. A corporation in due course of business during the calendar year 1918 declared and paid a dividend the major portion

[16] *Auditing, Theory and Practice,* Vol. I (1921 edition), by R. H. Montgomery, pages 670-677.

of which was paid out of earnings of the calendar years 1914, 1915, and 1916. Both at the time of declaration and at the time of payment of such dividend the Revenue Act of 1916 as amended by the Revenue Act of 1917 (see sec. 31 (b)) was in force, which provided for the taxation of dividends "at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation." In the calendar year 1919, after the passage of the Revenue Act of 1918 which changed the method of taxing cash dividends so that they became taxable at current rates, the corporation took action purporting to rescind the declaration of the dividend, and the stockholders repaid the amounts received by them from the corporation. It is inferred from the statement of facts that the declaration and payment of the dividend were legal and that the corporation could not have required the stockholders to pay back the amounts received in distribution but that such repayments were made voluntarily. . . . .

The rights of the stockholders with respect to the dividend became fixed at some time not later than the date of payment thereof. Such rights were not subject to any liability to repay amounts received. The dividend, therefore, became during the calendar year 1918 a part of the gross income of the stockholders. After it had acquired the character of gross income the stockholders could not by voluntary action on their part take away such character. The repayment of the dividend was a new and independent transaction. . . . . (C. B. 1, page 65; T. B. R. 42.)

The author wholly disagrees with the foregoing ruling. When the dividend was declared and paid the stockholders were justified in assuming that Congress would keep faith with the corporations which were induced to pay special dividends in 1918 under a guarantee of special treatment.[17] Congress did not keep faith and later imposed a different rate of tax by retroactive legislation. The corporations having acted under a law which was subsequently repealed were legally entitled to rescind what was done under a mistaken idea of the good faith of the government. The government having secured action through deceit is estopped from benefitting by such action.

In a subsequent case, the Treasury held that the repayment of a dividend did not relieve the stockholders of surtax thereon, even though the original payment of the dividend

[17] See page 722.

was made before proper provision had been made for federal taxes, resulting in an impairment of capital.

Ruling. . . . At the time of the declaration of the dividend the corporation had earnings and profits accumulated since February 28, 1913, out of which the dividends could be paid. In December, 1919, additional income and excess profits taxes were found to be due from this corporation for the year 1917, the collection of which would seriously have impaired the capital of the corporation. It was therefore agreed at a meeting of the stockholders, held in December, 1919, that the dividends previously paid should be returned to the corporation. . . . .

It might be inferred . . . . that no dividends may be declared from surplus and undivided profits unless a reserve fund is established for the payment of any Federal taxes which might accrue for the year prior to that in which the dividend is declared. However, such a principle could not be applicable to all prior years in which additional assessments might be made. The Commissioner is empowered, under the Revenue Act of 1918, to make an additional assessment of income and excess profits taxes for any given year at any time within five years after the return was due or was made, and in the case of a false or fraudulent return with intent to evade the tax the amount of tax due may be determined and collected at any time after the return is filed (section 250 (d)). It is apparent, therefore, that if we are to take into consideration a contingent liability that arises by reason of additional assessment, no point of time will arrive at which directors may safely say that earned surplus and undivided profits are available for distribution to stockholders in the form of dividends. . . . (C. B. 4, page 73; Sol. Op. 110.)

The foregoing ruling is not sound. The repayment of the dividend was an honest and legal method of rectifying a mistake. The attempt of the Treasury to force the payment of income taxes on an improper diversion of funds, ignoring the return of the funds, is inexcusable. However, in a recent case[18] the Treasury held that, when a liquidating dividend was excessive (and therefore illegal) but where no intention to reduce taxation was present, the taxpayer could make an amended return for the year when the dividend out of capital was received, on the ground that it was not income.

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[18] See C. B. I-1, page 17; I. T. 1164.

Distributions by foreign corporations considered "dividends."—In the definition quoted on page 703 the term "dividend" is held to include a distribution by a foreign as well as by a domestic corporation, but the 1921 law[19] imposes a definite limitation on such dividends before they can be free of the normal tax in the hands of individual stockholders, or from income tax imposed on a corporation recipient, i.e., more than 50 per cent of the gross income of the foreign corporation paying the dividend, for the three-year period prior to declaration of the dividend, must have been from sources *within* the United States.

The insertion of this limitation in the 1921 law was to prevent the recipient of dividends from a foreign corporation securing credit for normal tax on income when normal tax has never been paid by the foreign corporation. In other words, if the business of a foreign corporation in the United States is so small or so unprofitable as to yield little or no tax, the recipient of dividends will not now secure credit for a tax which has not been collected from the corporation.[20]

Return for dividends from foreign corporations.—Receipt by an individual of a $250 dividend on the ordinary shares of a British company indicates that the dividend credited was $333.33, and that the company paid to the British government an income tax of 25 per cent, or $83.33. If the British company received more than 50 per cent of its gross income for the three-year period preceding the declaration of

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[19] Sections 216 (a), 234 (a-6).

[20] **[Former Procedure]**

Ruling. Individuals are entitled to a credit for the purposes of the normal tax, of dividends, regardless of the amount of such dividends, received from a foreign corporation taxable upon income from sources within the United States, irrespective of the amount of such income. This applies equally to the Revenue Acts of 1916, 1917 and 1918. The same credit is allowed to corporations under the Revenue Act of 1917, for the purpose of the 4 per cent war income tax imposed by section 4 of that Act, but not for the purpose of the 2 per cent tax imposed by section 10 (a), Revenue Act of 1916 as amended by the Revenue Act of 1917. (C. B. 2, page 159; O. D. 383.)

the dividend, from sources within the United States, the gross amount ($333.33) should be entered in the return as a dividend subject to surtax only. When the British company received less than 50 per cent of its gross income from the United States as above noted, the full dividend ($333.33) must be entered as subject to both normal tax and surtax. In both cases, credit for the appropriate proportion of the foreign tax is taken in accordance with section 222.[21]

Distributions received from personal service corporations after January 1, 1918, may or may not be "dividends."—Under section 201 (a), quoted on page 702, distributions by personal service corporations lose their character as "dividends" when made out of earnings or profits accumulated after December 31, 1917, and prior to January 1, 1922.

Any distribution received from a personal service corporation must be analyzed. If declared out of earnings accumulated after December 31, 1917, and prior to January 1, 1922, it must not be treated as a dividend. If the personal service corporation has not paid the tax on it, it is subject to both normal tax and surtax in the hands of the recipient. If declared from earnings accumulated prior to January 1, 1918, or after December 31, 1921, it is subject to the surtax or exempt from all tax, the same as an ordinary cash dividend would be.

The reason for this is that, except for the period lying between the specified dates, personal service corporations were taxed like regular corporations. During the four-year period, their earnings were taxed to the individual stockholders at normal and surtax rates in the same manner as partnerships.[22] Thus, to determine the extent to which a "dividend" from a personal service corporation is taxable, it is necessary to consider three periods:

[21] See Chapter XXXIII for limitation on credit for foreign taxes.
[22] 1918 law, section 218 (e).

1. March 1, 1913, to December 31, 1917, inclusive.
2. January 1, 1918, to December 31, 1921, inclusive.
3. After December 31, 1921.

If the "dividend" is from earnings accumulated during (1) and (3), it is subject only to surtax, like a regular dividend. If from (2), it is not a "dividend" at all and is not subject to tax in the hands of the recipient since the tax on such earnings has already been imposed on the individual stockholders.[23] Earnings prior to March 1, 1913, are tax-exempt when distributed by personal service corporations, just as are the earnings of ordinary corporations.

Since the earnings of personal service corporations accumulated after December 31, 1917, and prior to January 1, 1922, are to be treated by the stockholders as income from a partnership, income received by the personal service corporation, such as tax-exempt interest or dividends from federal land banks or national farm loan associations, should have been reported to the stockholders separately, in order that the exemption to which the stockholders are entitled could be claimed. In making return on form 1040 the stockholders should segregate the receipts from personal service corporations after December 31, 1917, excluding any dividends which constitute a distribution of profits accumulated after December 31, 1917, and prior to January 1, 1922. The part of the undistributed income of the personal service corporation which accrued to the stockholders during the four-year period, should be reported in the year of accrual as Item 3.[24] Dividends received by stockholders of personal service corporations after January 1, 1918, which constitute a distribution of earnings prior to that date, should be reported the same as dividends from ordinary corporations. Dividends received out of earnings accumulated after December 31, 1921, will also be entered the same as dividends from ordinary corporations.

[23] For discussion of personal service corporations having fiscal years, see *Income Tax Procedure,* 1922, page 820.

[24] Item 9, schedule E of form 1040, used in 1920.

After December 31, 1921, dividends paid by personal service corporations are subject to the provisions of section 201 (b).[25] Dividends paid during 1922 will be applied first to earnings accumulated ratably during 1922. If a personal service corporation declared a dividend in March, 1922, payable April 1, 1922, it will be held that it must first be applied against earnings accrued from January 1 to March 31, 1922, even though earnings accumulated prior thereto on which normal tax and surtax had already been paid by the stockholders, had not been fully distributed.[26]

Distributions Not Taxable as "Dividends"

Three types of so-called "dividends" may be excluded from gross income:

1. Distributions from appreciation accrued prior to March 1, 1913;
2. Distributions from earnings accumulated prior to March 1, 1913; and
3. Liquidating dividends (including dividends stated to be paid from depletion and depreciation reserves) to the extent that they are a return of capital.

The words "or increase in value of property" were inserted in section 201 (b) of the 1921 law, quoted on page 738, so as to remove all doubt[27] regarding the exempt character of dividends paid out of appreciation at March 1, 1913, provided

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[25] See page 738.

[26] Assume that a personal service corporation had a surplus at December 31, 1921, of $200,000, all accumulated since January 1, 1918. The normal tax and surtax thereon has been paid by the individual stockholders. Assume further that the earnings from January 1 to February 28, 1922, were $20,000. On February 28, 1922, a dividend of $15,000 was paid. The sixty-day rule is not applicable after December 31, 1921. The entire dividend of $15,000 would be deemed to have been out of 1922 earnings and taxable to the stockholders at the 1922 surtax rates, but exempt from normal tax. No part of the $200,000 surplus could be distributed free from tax until all earnings since December 31, 1921, are first distributed.

[27] For ruling of the Treasury (since revoked) that under the 1918 law dividends paid out of realized appreciation at March 1, 1913, are taxable, and discussion thereon, see *Income Tax Procedure*, 1922, pages 718 to 725.

the earnings accumulated since that date are first distributed. After a long struggle the Treasury has at last recognized the soundness of the position which has been consistently maintained by the author that it was the intention of Congress to exempt such dividends under the 1916, 1917 and 1918 laws as well.

Regulation. Any distribution by a corporation out of earnings or profits accumulated prior to March 1, 1913, or out of increase of value of property accrued prior to March 1, 1913 (whether or not realized by sale or other disposition), is not a dividend within the meaning of the Act. The provisions of the preceding sentence shall be applied uniformly to cases arising under the Revenue Act of 1916, the Revenue Act of 1917, the Revenue Act of 1918, as well as the Revenue Act of 1921. A corporation can not distribute earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, unless and until all earnings or profits accumulated since February 28, 1913, have been distributed. In determining whether a dividend is out of earnings or profits accumulated prior or subsequent to March 1, 1913, due consideration must be given to the facts and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. . . . . (Art. 1543.)

In the opinion of the author, article 1543 correctly interprets the law.

Under the 1913 law the Supreme Court has held that cash dividends declared between March 1, 1913, and December 31, 1915, even though admittedly out of surplus accrued prior to March 1, 1913, are taxable.[28] The decisions would seem to be controlling so far as ordinary cash dividends paid prior to December 31, 1915, are concerned, but in other decisions the Supreme Court has held that special circumstances would justify a departure from the former decision, so that cash dividends paid after March 1, 1913, have in some cases been held free from taxation[29] and in other cases subject to the tax.

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[28] *Lynch v. Hornby,* 247 U. S. 339, 38 Sup. Ct. 543, 62 L. Ed. 1149; *Peabody v. Eisner,* 247 U. S. 347, 37 Sup. Ct. 546, 62 L. Ed. 1152.

[29] *Southern Pacific Co. v. Lowe,* 247 U. S. 330, 38 Sup. Ct. 540, 62 L. Ed. 1142; *Gulf Oil Corp. v. Lewellyn,* 248 U. S. 71, 39 Sup. Ct. 35, 63 L. Ed. 133.

The 1916 law[30] definitely declared that earnings accumulated prior to March 1, 1913, had been capitalized and that dividends therefrom were free from all income taxes. No provision was made that the earnings subsequent to March 1, 1913, should be exhausted before declaring dividends out of the prior period.

Under the 1916 law the Treasury made no effort to restrict the payment of dividends out of surplus accrued prior to March 1, 1913, but very properly required evidence that the corporations were keeping strict account of the disposition of the surplus at that date.

The Treasury Department consistently interpreted the 1916 law to mean that a board of directors might specify the period to which dividends applied, and, if a surplus existed at March 1, 1913, and a board of directors informed stockholders that a certain dividend applied thereto, such dividend was not returnable and of course not taxable to the stockholder.

In the first drafts of the revenue bill of 1917 it was provided that all dividends declared during 1917 were applicable first to the latest earnings of corporations. As many special cash and stock dividends (declared after January 1, 1917) had been designated as payable out of surplus at March 1, 1913, and as most of such dividends would not have been paid at 1913, and as most such dividends would not have been paid at all if subject to the 1917 income tax rates, great injustice would have been done if no change had been made in the draft.

It was finally decided that the application of dividends to the latest earnings should be obligatory only from August 6, 1917. This was the date on which the Senate Finance Committee reported the revenue bill as amended to the Senate. As reported, the bill indicated the intention to compel the distribution of all earnings subsequent to March 1, 1913, before the

[30] The language of the 1916 law was as follows:

Section 31. (a) That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company. . . . .

surplus at that date could be distributed. This was sufficient notice of a radical change in the 1916 law, and directors who declared dividends during 1917 but after August 6, were chargeable with a knowledge that the 1916 law was to be amended.[31]

Dividends out of surplus prior to March 1, 1913.—As late as October 21, 1921, the Treasury issued an opinion[32] which held that profit realized by a corporation between cost and March 1, 1913, value of property sold in 1918 (or in subsequent years) was taxable as income when distributed as dividends to stockholders. This position, the unsoundness of which is discussed at length in *Income Tax Procedure,* 1922, pages 718-725, was entirely abandoned by the Treasury in article 1543 of Regulations 62 quoted on page 713.

RULING. Law Opinion 1073 (C. B. 5, p. 26), holding that profit made by a corporation in 1918 or subsequent years from the realization of appreciation of corporate assets accrued before March 1, 1913, was taxable income to the stockholder when distributed as a dividend in 1918 or subsequent years, has been superseded by article 1543 of Regulations 62. The provisions of this article are to be applied uniformly to cases arising under the Revenue Act of 1916, the Revenue Act of 1917, and the Revenue Act of 1918, as well as the Revenue Act of 1921.

Any distribution of the nature above outlined made in the years 1913, 1914, or 1915 is subject to tax in accordance with the decision of the United States Supreme Court in the case of *Lynch v. Hornby* (247 U. S., 339), T. D. 2731 (not published in Bulletin service). (C. B. I-1, page 17; I. T. 1303.)

Application of tax-free distributions in computing gains and losses.—The second sentence of section 201 (b) provides that in computing losses in final realization, prior tax-free distributions must be credited as partial returns of capital. Section 201 (c), however, provides that in computing gains in final realization, prior tax-free distributions may be ignored.

For illustration see Chapter XXXIV.

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[31] See Reg. 33, 1918, Art. 107; and C. B. 3, page 36; O. D. 655.
[32] C. B. 5, page 26; L. O. 1073.

Distribution from proceeds of a claim at March 1, 1913.— The fact that what a corporation had at March 1, 1913, was capital and that payments out of capital are not taxable income, is clearly stated in a case,[33] decided under the 1916 law.

Decision. The item represented, therefore, the distribution of the proceeds of a chose in action arising *ex delicto* long prior to March 1, 1913. It was compensation for an injury which John D. Park & Sons Co. had suffered by reason of a violation of the anti-trust law. It was not in itself a profit, but was indemnification for a wrong which had caused a loss of profits. On March 1, 1913, it was represented by an accrued chose in action. On November 1, 1916, it was reduced to cash.

By the Act of 1913 dividends were taxable if paid after March 1, 1913, whether from profits theretofore accrued or thereafter. Lynch v. Hornby, 247 U. S. 339. . . . . But by the Act of 1916 taxable dividends were limited to those made out of earnings or profits accrued since March 1, 1913. And, I take it, whatever claims the corporation had upon that date, whether arising from profit or otherwise, are to be considered as capital then accrued, for the purposes of this act, and that profit since accrued means after-acquired gain, which did not then exist, and that the mere fact that a then existing claim, even though representing a profit, was afterwards collected, would not make it a profit accrued after the prescribed date. The same limitation was carried in the amendment of October 3, 1917, and substantially the same in Section 201 of the Act of 1918, the date being there changed to February 28, 1913. Any distribution of property or money accumulated by a corporation prior to March 1, 1913, has not been taxable as income at any time since the enactment of the Act of September 8, 1916. And it was under that act that the taxes in question were imposed. Therefore, the distribution of the sum realized from the compromise of the chose in action under discussion was not a dividend taxable as income unless that sum can be regarded as representing profit accrued after March 1, 1913.

The brief filed by the Government rests its contention upon the proposition that when a dividend is declared and paid by a corporation such dividend is presumed to have been paid from profits, and not from capital, and that if the value of the capital of this corporation, after the distribution of said sum of $85,000, was equal to its value of March 1, 1913, the distribution of the $85,000 was a distribution of the profits, and the shares received by the plaintiffs were taxable in-

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[33] *Park v. Gilligan, Collector,* U. S. Dist. Ct., So. Dist. of Ohio, West. Div., June 11, 1921 (not reported); see Corp. Tr. Co. 1922 *Income Tax Service,* § 1261 *et seq.*

come. But the evidence is that all, or practically all, of the profits that accrued to this corporation between March 1, 1913, and January 1, 1917, were paid out in other dividends, and it was impossible that this $85,000 could have been paid out of earnings on hand. The corporate surplus was practically exhausted by the payment of such other dividends from year to year. Therefore, the presumption upon which the argument of the Government, as set forth in the brief, rests, to-wit, that this distribution was made from profits accumulated within the taxable period, is overcome by the evidence. The fact is that this asset, which had accrued and existed in the form of a chose in action at and long prior to March 1, 1913, was on November 1, 1916, realized upon and distributed, and the corporate property as it stood at the former date was thereby diminished accordingly. There is no evidence that this chose in action was of any greater value on the latter date than it was on the former. Therefore, as this distribution was not out of profits accrued since the statutory date, it was not taxable to the distributees as income.

The foregoing decision of the court is in entire agreement with the contentions of the author and the most recent position of the Treasury that under the 1916 and subsequent laws dividends paid out of capital at March 1, 1913, whether on the books or not, were not taxable, even though paid prior to January 1, 1921.

Dividends declared prior to March 1, 1913.—The following recent court decision[34] holds that a declaration of a dividend creates a debt; therefore, a dividend declared prior to March 1, 1913, but paid later is not taxable income.

Decision. We think that the dividend declared prior to March 1, 1913, the effective date of the Income Tax Act here considered, was not income when paid because it was part of the capital of the defendant in error on March 1, 1913. By the declaration of a dividend, the earnings of the company to the extent declared were separated from the property of the corporation and were appropriated by that action to the then stockholders, who became creditors of the corporation for the amount of the dividend. The relation then created was that of debtor and creditor. . . . It is the separation of the earnings from the balance of the corporate property, together with the promise to pay arising from the declaration of the dividend, that works this change. The holder of stock, with respect to the divi-

[34] *United States v. Guinzburg,* 278 Fed. 363; C. B. I-1, page 15; Ct. D. 23.

dend, is on a par with the other creditors of the corporation. . . . . The fact that the dividend is payable at a future date does not alter the rights thus created. The obligation of the corporation as debtor commences with the declaration of the dividend, although the payment is postponed for the convenience of the company. The rights of the stockholders are immediately vested the moment the dividend is declared. . . . . The action of the board of directors is the appropriation of a portion of the earnings to the defendant in error as the holder of a certificate of stock. . . . .

We conclude that, upon the declaration of a dividend, the debt was immediately created in favor of the defendant in error, payable at a future date. By that action a vested right was created in favor of the stockholder, who could sell his right by assigning or pledging or otherwise disposing of it, and this was not income arising and accruing within the meaning of the statute, such as might be taxed under the Income Tax Act of March 1, 1913, here in question. The same views are expressed in the rulings of the Treasury Department. (Treasury Decision 2048, Nov. 12, 1914.)

Rentals paid to stockholders.—In a recent case[35] the trustee in bankruptcy had deducted from the bankrupt's gross income as an expense of operation certain rentals for films which the Treasury claimed were a distribution of net profits. The bankrupt had contracted with ten manufacturers of moving picture films, each originally owning one-tenth of the bankrupt's common stock, whereby they were to lease to it their films at a certain sum per foot plus a payment at the end of the year, which payment was to be made from the bankrupt's net profits during the year in excess of a specified dividend on its stock. Since this additional payment was based entirely upon the amount of film footage each lessor had furnished the bankrupt during the year and had no reference to the stockholdings, it was held that these additional payments were properly deductible as additional rent and did not constitute an attempt to distribute surplus to stockholders.

Allocation of Dividends to Periods When Accumulated

The determination of the period to which dividend payments should be allocated has demanded much attention.

[35] *In re General Film Corporation,* 274 Fed. 903.

Dividends, for purposes of allocation, under the 1921 law may be separated into four classes, i.e., as paid from:

1. Earnings accumulated since February 28, 1913.
2. Earnings accumulated prior to March 1, 1913.
3. Appreciation in value accrued prior to March 1, 1913.
4. Capital.

LAW. Section 201. . . . . **(b) For the purposes of this Act every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913;**[36] . . . .

The Treasury has gone to considerable length in explaining its position regarding the manner of applying the rule laid down in the section of the law quoted above. Apparently one of the first rulings on this subject was questioned and the very full, but faulty, ruling, quoted in part below, was issued.

RULING. The word "accumulated," as used in the phrase "accumulated since February 28, 1913," in ruling 31-20-1098, O. D. 610, means, in the judgment of the Committee, profits which have been earned and not dissipated by subsequent losses. While it is recognized that assets can not be earmarked as representing earnings of

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[36] **[Former Procedure]** The following section of the 1921 law was a re-enactment of 201 (e) of the 1918 law, for the purpose of determining invested capital only, not for computing income taxes. It lost its significance with the repeal of the excess profits tax.

LAW. Section 201. . . . . (f) Any distribution made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution, to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits, the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period. This subdivision shall not be in effect after December 31, 1921.

Article 1542 (b) of Regulations 62 refers to section 201 (f) and to dividends of personal service corporations. See *Income Tax Procedure, 1922*, pages 728-729.

The Committee in a recent ruling (I-29-409; A. R. R. 1000) has held that the word "deemed" in section 201 (b) of the 1918 law means "adjudged, decided, regarded, determined."

any particular year, it is a fair assumption that the earliest surplus of a corporation is likely to be represented in its balance sheet by fixed assets, while the later earnings are more apt to be represented by liquid assets. Consequently any losses sustained in a given year will be met out of the most recent earnings embraced in its surplus. It follows that profits of any year can not be diminished by prior losses, but it is fair to assume that such earnings, to the extent necessary, will go to satisfy subsequent losses. There is no obligation to recognize for tax purposes the surplus of March 1, 1913, as capital which must be made good before there can be any distribution of profits. (C. B. 3, page 36; Digest A. R. M. 82.)

In the detailed ruling the following illustration is given:

Earnings	Losses	Surplus
Mar. 1 to Dec.	Jan. 1/14 to Dec.	Mar. 1/13. $100,000
31/13 ....$10,000	31/16 ....$25,000	Dec. 31/13. 110,000
Jan. 1 to Dec.		Dec. 31/16. 85,000
31/17 15,000	Jan. 1 to Dec.	Dec. 31/17. 100,000
Jan. 1 to Dec.	31/18 10,000	Dec. 31/18. 90,000
31/19 5,000		Dec. 31/19. 95,000
Jan. 1/20 to date		
of dividend.. 15,000	Dividend, 1920.$25,000	

The most recent loss shown is that of 1918. This, of course, was met out of earlier earnings and the corporation must have on hand at the present time the $5,000 earned in 1919 as well as the $15,000 earned in the current year. Of the $15,000 earned in 1917, $10,000 was lost in 1918, leaving it with $5,000 earnings of 1917 still on hand. The $15,000 of 1920 earnings, together with the $5,000 of 1919 earnings and the $5,000, remaining of 1917 earnings covers the dividend of $25,000, showing that all of the dividend was paid out of earnings accumulated since March 1, 1913, notwithstanding the fact that the company's surplus on December 31, 1919, was $5,000 less than it was on March 1, 1913. From this it might be argued that necessarily, since its surplus on December 31, 1919, was less than that of March 1, 1913, any distribution in excess of the earnings of 1920 must have come out of the March 1 surplus. This, however, is a fallacy since there is no obligation to recognize for tax purposes the surplus of March 1, 1913, as capital which must be made good before there can be any distribution of profits. . . . .

A corporation with a surplus of $100,000 on March 1, 1913, might have losses in alternate years up to 1923 aggregating $100,000 and profits in other years (all paid out in

dividends) aggregating the same amount. The effect of the ruling would be that on January 1, 1923, it would have no surplus. The surplus at March 1, 1913, which was supposed to be free from tax, would in effect all have been taxed, although the dividends paid exactly exhausted that surplus.

If no dividends were paid, the corporation on January 1, 1923, would have a surplus of $100,000, all of which would be deemed to have been earned after March 1, 1913.

The foregoing ruling was seriously questioned in an article in the *Journal of Accountancy,* which said in part:[37]

> In the supposititious case a corporation was in possession of a surplus of say $100,000, March 1, 1913. During the period ended December 31, 1919, it sustained a net loss of $5,000, thereby reducing its surplus to $95,000. It declared a dividend of $25,000 some time in 1920, during which year and up to date of which declaration its earnings are supposed to have been $15,000. Hence, under the most limited interpretation the corporation must have paid its dividend out of the $15,000 earned in 1920, and $10,000 out of its surplus earnings of March 1, 1913.
>
> The department has ruled that because the corporation earned, say, $5,000 in 1919 and $15,000 in 1920, only $5,000 of the $25,000 dividend could be considered to have been paid out of the surplus of March 1, 1913. Truly a remarkable decision reached by a unique method of reasoning.

In the foregoing ruling the Treasury declines to recognize surplus at March 1, 1913, as capital, but in the ruling given below, dividends paid during the first 60 days of 1918, which under the law should have been applied first to earnings accumulated during preceding taxable years (note the plural), were taxed at the 1918 rates, on the ground that the years prior to 1913 were not taxable years. In the latter case surplus at March 1, 1913, is treated as capital. In the former case the surplus at March 1, 1913, is treated as if it were taxable earnings. The rulings are not consistent and one of them must be erroneous. The author is of the opinion that the following ruling is sound and that the one on page 719 is unsound.

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[37] *Journal of Accountancy,* Income Tax Department, November, 1920.

Ruling. Where a corporation has profits accumulated prior to March 1, 1913, but none accumulated between that date and January 1, 1918, and pays dividends during the first 60 days of 1918, such dividends will be deemed to have been paid from earnings or profits accumulated after December 31, 1917. (C. B. 1, page 26; Digest T. B. R. 43.)

The definition of the word "accumulated" in A. R. M. 82 merely states that it means "profits which have been earned and not dissipated." The definition is not in accord with the ordinary meaning of the word.

Effect of stock dividend on surplus at March 1, 1913.—
Ruling. . . . . Where a corporation, having a surplus accumulated in part prior to March 1, 1913, and being thereunto lawfully authorized, transfers to its capital account a portion of its surplus, issues new stock representing the amount so transferred to the capital account and then declares a dividend payable in part in cash and in part in shares of the new issue of stock, that portion of the dividend paid in cash will be deemed to have been paid out of surplus accumulated since February 28, 1913, to the extent of the earnings and profits accumulated since that date, and is subject to tax, but the portion of the dividend paid in stock will not be subject to tax as income. (C. B. 3, page 23; O. D. 587.)

This ruling is in accord with good accounting practice. The foregoing ruling has recently been confirmed by an opinion of the Solicitor (I-40-529; Sol. Op. 144.)

All cash dividends received after January 1, 1918, taxable at rates in force in period when received.[38]—Under both the 1918 and 1921 laws, all dividends (except stock dividends) are taxable to the recipients as income at the rates in force for the period during which the dividends are received.[39]

Dividends Paid Otherwise Than in Cash

Regulation. Dividends paid in securities or other property (other than its own stock), in which the earnings of a corporation

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[38] For former procedure as to dividends taxable at rates of former years, see *Income Tax Procedure*, 1920, pages 485-487.

[39] Section 211 (a-2). For discussion regarding taxability of dividends under the 1917 law on the basis of the year in which earned, see *Income Tax Procedure*, 1920, page 485, and *Income Tax Procedure*, 1921, page 575.

have been invested, are income to the recipients to the amount of the market value of such property when receivable by the stockholders. . . . . (Art. 1547.)

Most dividends are paid in cash or in stock, but occasionally distributions are made in some other form. When a dividend other than cash or stock is received, it should be returned for taxation at its cash value. If its equivalent cash value cannot be ascertained at time of receipt it should be returned when and if cash value can be determined.

In the foregoing regulation no mention is made of any restriction upon the credit which may be taken for the normal tax. The law defines a dividend to be "any distribution made by a corporation . . . . out of its earnings or profits."[40] In one section of the 1918 law there is an indication that the credit for the normal tax is based upon and limited to the earnings or profits upon which income tax has been imposed.[41] It is logical and proper that a taxpayer should receive credit only for the normal tax upon an amount equal to the earnings which have paid the tax.

In the 1921 law, dividends from foreign corporations deriving 50 per cent or more of their gross income from *outside* the United States may not be credited for normal tax.

The courts have drawn a very fine distinction between dividends which are in final liquidation and those which are "recurring" or which leave the capital intact. In 1916 and 1918 the Supreme Court of the United States decided several cases which must be deemed to be conclusive of these factors.[42]

Dividends paid in stock of another corporation.—

REGULATION. . . . . A dividend paid in stock of another corporation is not a stock dividend, even though the stock distributed was acquired through the transfer by the corporation declaring the dividend, of property to the corporation the stock of which is distributed as a dividend. Where a corporation declares a dividend pay-

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[40] Section 201 (a).
[41] Section 216 (a), 1918 law.
[42] *Lynch v. Turrish*, 247 U. S. 221, 38 Sup. Ct. 537, 62 L. Ed. 1087; *Lynch v. Hornby*, 247 U. S. 339, 38 Sup. Ct. 543, 62 L. Ed. 1149; *Brushaber v. Union Pac. Ry. Co.*, 240 U. S. 1, Sup. Ct. 236, 60 L. Ed. 493.

able in stock of another corporation, setting aside the stock to be so distributed and notifying the stockholders of its action, the income arising to the recipients of such stock is its market value at the time the dividend becomes payable. . . . .[43] (Art. 1547.)

It will be noted that the rule of a "market value" is reiterated in this regulation.

When a dividend is paid in the stock of other companies, or in property, which has a fair market value, or a readily realizable value, *and* when the capital stock of the paying corporation remains unimpaired, the dividends are taxable as ordinary cash dividends.

The foregoing principles were affirmed in the cases of *Rockefeller v. United States,*[44] *New York Trust Company, et al. v. Edwards,*[45] and *United States v. Phellis.*[46] In these cases dividends were paid in the stock of a pipe line company and in the stocks and securities of a powder company. In each case the securities distributed had a known and realizable market value and the capital of the paying company was unimpaired by the distribution. In other words, the court held that the dividends were paid from surplus. In each case value at March 1, 1913, was taken into consideration.

The court said in the *Rockefeller* case:

Decision. . . . . The distribution, whatever its effect upon the aggregate interests of the mass of stockholders, constituted in the case of each individual a gain in the form of actual exchangeable assets transferred to him from the oil company for his separate use in partial realization of his former indivisible and contingent interest in the corporate surplus. It was in substance and effect, not merely in form, a dividend of profits by the corporation, and individual income to the stockholder. . . . .

In the *Phellis* case the court said:

Decision. . . . . After the reorganization and the distribution of the stock of the Delaware corporation, the New Jersey corporation continued as a going concern, and still exists, but, except for the redemption of its outstanding bonds, the exchange of debenture stock

[43] See Art. 53.
[44] 42 Sup. Ct. 68, 66 L. Ed. —.
[45] 42 Sup. Ct. 68, 66 L. Ed. —.
[46] 42 Sup. Ct. 63, 66 L. Ed. —.

for its preferred stock, and the holding of debenture stock to an amount equivalent to its own outstanding common, and the collection and disposition of dividends thereon, it has done no business. It is not, however, in process of liquidation. . . . .

Upon the face of things, however, the transfer of the old company's assets to the new company in exchange for the securities issued by the latter, and the distribution of those securities by the old company among its stockholders, changed the former situation materially. The common stock of the new company, after its transfer to the old company and prior to its distribution, constituted assets of the old company which it now held to represent its surplus of accumulated profits,—still, however, a common fund in which the individual stockholders of the old company had no separate interest. But when this common stock was distributed among the common stockholders of the old company as a dividend, then at once—unless the two companies must be regarded as substantially identical—the individual stockholders of the old company, including claimant, received assets of exchangeable and actual value severed from their capital interest in the old company, proceeding from it as the result of a division of former corporate profits, and drawn by them severally for their individual and separate use and benefit. Such a gain, resulting from their ownership of stock in the old company and proceeding from it constituted individual income in the proper sense. . . . .

. . . . The proposed plan was set out in a written communication from the president of the New Jersey corporation to the stockholders, a written assent signed by about 90 per cent of the stockholders, a written agreement made between the old company and the new, and a bill of sale made by the former to the latter, all of which are in the findings. The plan as thus proposed and adopted, and as carried out, involved the formation of a *new corporation*[47] to take over the business and the business assets of the old; it was to be and was formed under the laws of a *different state,* which necessarily imports a different measure of responsibility to the public, and presumably different rights between stockholders and company and between stockholders *inter sese,* than before. The articles of association of neither company are made to appear, but, in favor of the asserted identity between the companies, we will assume (contrary to the probabilities) that there was no significant difference here. But the new company was to have authorized capital stock aggregating $240,000,000,—nearly four times the aggregate stock issues and funded debt of the old company,—of which less than one-half ($118,515,900) was to be issued presently to the old company or its stockholders, leaving the future disposition of a majority of the authorized new issues still to be determined. There was no present change of officers or stockholders, but manifestly a continuation of identity in this

[47] The italics appearing here and later are the court's.

respect depended upon continued unanimous consent or concurrent action of a multitude of individual stockholders, actuated by motives and influences necessarily to some extent divergent. In the light of all this, we can not regard the new company as virtually identical with the old, but must treat it as a substantial corporate body with its own separate identity, and its stockholders as having property rights and interests materially different from those incident to ownership of stock in the old company. . . . .

It thus appears that, in substance and fact, as well as in appearance, the dividend received by claimant was a gain, a profit, derived from his capital interest in the old company, not in liquidation of the capital, but in distribution of accumulated profits of the company,—something of exchangeable value produced by and proceeding from his investment therein, severed from it, and drawn by him for his separate use. Hence it constituted individual income within the meaning of the Income Tax Law, as clearly as was the case in *Peabody v. Eisner,* 247 U. S. 347. . . . .

The court failed to state in the foregoing cases what its decision would have been if any one of the old companies had distributed all or part of its capital. The court's use of italics would justify the inference that, if the capital of the old companies had been distributed, the substance of the transactions would have been that the stockholders received nothing in the way of taxable income, provided that the new securities were ratably issued to the old stockholders who thereafter merely owned what they had owned before the distribution and that there was a change in form only. In the *Phellis* case the court said:

Decision. . . . . We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder. In a number of cases besides those just cited we have, under varying conditions, followed the rule. *Lynch v. Turrish,* 247 U. S. 221; *Southern Pacific Co. v. Lowe,* 247 *U. S.* 330; *Gulf Oil Corporation v. Lewellyn,* 248 U. S. 71.

It would appear, therefore, that the court regarded the unimpairment of the capital of the old companies as a factor of substance.

A dividend paid in the stock of another corporation is treated as a cash dividend if the readily realizable market

value can be determined. In such case the credit for the normal tax may be taken.

Dividends paid in Liberty bonds and other government securities.—Many corporations have paid dividends in the form of United States bonds.[48] Some stockholders formed the opinion that, because the income from the 3½ per cent Liberty bonds was entirely tax-free, no tax would accrue to income received in the form of the bonds themselves. This view, of course, was erroneous because the tax is assessed against the receipt of the dividend and, so long as the dividend is received in cash or its equivalent, the tax should be levied. The case is precisely the same as if the corporation declared the dividend in cash and the stockholder purchased tax-free securities with the proceeds.[49] When Liberty bonds are selling at a discount, the tax can be assessed only on the cash value of the dividend.[50]

Dividends paid in bonds which sell at a considerable discount should be entered by the recipients at the market value of the securities received. If the securities are subsequently sold at a lower price, credit may be claimed for the loss sustained. If sold at a higher price, the profit realized should be reported.

Dividends other than in cash are not closed and completed transactions when the property received has no "readily realizable market value." But the rule is of slight significance in the case of government bonds which are so nearly the equivalent of cash that fluctuations which may be only temporary can be disregarded.

Dividends paid from tax-exempt interest.—

REGULATION. . . . . Although interest on State bonds and certain other obligations is not taxable when received by a corporation,

[48] For opinion of the Attorney General of the United States on the taxability of dividends paid in tax-exempt bonds, see *Income Tax Procedure*, 1918, pages 154-156.

[49] Conversely, the corporation is permitted to take the loss. (C. B. 4, page 27; A. R. R. 435.)

[50] Letter from Deputy Commissioner L. F. Speer, November 12, 1918, and Art. 1547.

upon amalgamation with the other funds of the corporation such income loses its identity and when distributed to stockholders in dividends is taxable to the same extent as other dividends. . . . . (Art. 1541.)

On its face it would appear that it is inequitable to assess stockholders for surtaxes on dividends which can be identified as having been paid out of funds derived from tax-free securities. As owners of the corporation the stockholders in effect own the tax-free securities and in theory should pay no tax whatever on the income therefrom. But the fact that the corporation and its stockholders are separate entities prevents the practical application of the theory. If the directors of a corporation desire its stockholders to receive the benefit of the exemption it will be necessary first to distribute the securities to the stockholders. After the distribution to individual stockholders the income will be entirely free from taxation.

Dividends paid in debenture bonds.—In ruling that dividends paid in debenture bonds were taxable, the court said:

Decision. The plaintiffs received an actual payment (in the form of securities available for disposition in the market, and entirely severed or distinguished from their control of the property as stockholders) of profits which the company wished to distribute as earnings to its stockholders. . . . .[51]

Scrip dividends.—

Regulation. . . . . Scrip dividends are subject to tax in the year in which the warrants are issued. (Art. 1547.)

The rule of readily realizable market value is to be applied in this case also.

Scrip dividends are sometimes issued by corporations unable to pay cash, in which case the valuation of such scrip for tax purposes should be carefully considered.

Of course, if the scrip runs for a comparatively short period, as one or two years, and if the rate of interest it bears is

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[51] *Doerschuck v. U. S.*, and *Thomas v. U. S.*, 274 Fed. 739.

high enough, and also if the credit of the issuing corporation is good enough, then the recipient of the dividend might properly treat the scrip as a receipt of cash and return it accordingly. This, however, assumes that his books are kept on an accrual basis; if kept otherwise, when the scrip is redeemed in cash he may erroneously include it again.

For a person reporting on the basis of cash receipts, the safer method in the case of receipt of scrip of doubtful character, or which has no active market, would seem to be to wait until something more substantial is received than a "scrap of paper."

In the following ruling the principle of readily realizable market value and the equivalent of cash seems to have been ignored:

Ruling. The M Insurance Company issues certificates of profit based upon premiums received on marked-off risks of the previous year. These certificates mature in six years and are subject to the future losses and expenses of the company until redeemed and may be reduced by the board of trustees in the case of losses and expenses in any subsequent year exceeding the estimated profits of that year. Interest is payable annually upon the face value of the certificates.

Held, that the certificates are in the nature of scrip dividends in accordance with article 1544 of Regulations 45, and are taxable at the rate for the year in which declared or issued to the extent that they represent undistributed earnings or accumulated profits. Inasmuch as they are affected by the gains or losses of the company during their maturing period, the amount of such gain or loss should be accounted for in the taxable year in which the certificates mature or are redeemed.

The amount of interest annually payable on these certificates is taxable income for the year in which it is received. (C. B. 3, page 37; O. D. 589.)

If the certificates mentioned above are readily convertible into cash the market or discounted value thereof would seem to be the proper basis of the return.

Part of stock dividend paid in scrip.—

Ruling. A corporation declared a dividend payable in stock of the company at par and in making the distribution of fractions of

shares issued scrip certificates. These scrip certificates at the option of the stockholders were sold by the corporation as agent for the stockholders.

Held, that the scrip certificates do not represent a cash dividend but a stock dividend and are therefore not subject to tax. (C. B. 4, page 24; Digest O. D. 859.)

The profit on the scrip certificates sold would have to be computed as in the case of any other stock dividends.[52]

SCRIP DIVIDENDS REDEEMABLE IN CASH OR STOCK.—When scrip dividends give an option to the recipient to redeem the scrip in cash or stock, the question arises whether or not they are stock dividends, and therefore not taxable; particularly when the stock has a market value considerably above the amount payable in cash. When they are issued no liability is created, the only entries in the books being a debit to surplus and a credit to "scrip dividend payable." Therefore no tax can be imposed at that point, because no asset of any kind has been segregated or distributed. It is, in effect, merely a suspense account. If any stockholder takes cash, there is to that extent only a diminution of assets and a distribution. When all stockholders take stock there is no distribution, but there is a transfer from surplus to capital, and all the elements of a stock dividend are present.

Dividends on part-paid stock.—A corporation's stock was 80 per cent paid in. The directors authorized a journal entry to be made, debiting profit and loss and crediting capital stock, for an amount sufficient to make the stock full paid. The Committee held that the transaction was a cash—not a stock—dividend. (I-45-575; A. R. R. 1127.)

The ruling is sound. There was no distribution of assets, neither was there a dividend paid in stock. Until stock is fully paid, the unpaid portion is an obligation entered into by the stockholders when subscriptions are made. The discharge of this obligation partakes more of the nature of a

[52] See Chapter XXVIII.

cash than of a stock dividend. It would have been a simple matter to have made a stock dividend out of it, but the directors took another course.

Cash Dividends, the Taxability of Which (in Whole or in Part) Has Been Questioned

Dividends declared from depreciation and depletion reserves.—During 1917 certain corporations, particularly copper mining corporations, adopted a policy of declaring special dividends which were described as a return of capital and not a distribution of profits. As such distributions were charged to depletion reserves on the corporation's books, it was claimed that the surplus and undivided profits were not affected thereby and for this reason no tax could be assessed on the so-called dividends.

REGULATION. A reserve set up out of gross income by a corporation and maintained for the purpose of making good any loss of capital assets on account of depletion or depreciation is not a part of surplus out of which ordinary dividends may be paid. A distribution made from a depletion or depreciation reserve based upon the cost of the property will not be considered as having been paid out of earnings or profits, but the amount thereof shall be applied against and reduce the cost, or other basis, of the stock upon which declared for the purpose of determining the gain or loss from the subsequent sale of the stock. A distribution made from that portion of a depletion reserve based upon a valuation as of March 1, 1913, which is in excess of the depletion reserve based upon cost, will not be considered as having been paid out of earnings or profits, but the distributee shall not be allowed as a deduction from gross income any loss sustained from the sale or other disposition of his stock or shares unless, and then only to the extent that, the basis provided in section 202 exceeds the sum of (1) the amount realized from the sale or other disposition of such stock or shares, and (2) the aggregate amount of such distributions received by him thereon. No distribution, however, can be made from such a reserve until all the earnings or profits of the corporation have first been distributed. (Art. 1546.)

A recent ruling[53] holds that the principles of the foregoing regulation also apply to foreign corporations. Article 1546

[53] I-40-530; I. T. 1456.

differs from the corresponding one under the 1918 law (Regulations 45, article 1549)[54] in which a distribution from a depletion reserve is called a "liquidating dividend." It is clear, however, that after all profits accumulated since March 1, 1913, are distributed, a dividend from depletion reserve is:

1. A return of capital.
2. A reduction of the cost or March 1, 1913, value of the shares of stock.

A corporation should not be permitted to declare dividends out of capital so long as a surplus exists on the books. If no surplus exists, a distribution of capital should be coincident with a reduction in the capital stock of the corporation. Reserves are created for the purpose of keeping the capital intact, and any diminution of such reserves automatically reduces the capital. This should not be done unless stockholders can be depended upon to grasp the significance of the transaction. It is not likely that an ordinary stockholder who received a dividend described as having been charged to a depletion reserve would comprehend that it represented a distribution of capital. He would retain his stock certificate

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[54] **[Former Procedure]** The first ruling of the Treasury held that dividends out of depletion reserves were not taxable, as indicated by the following:

RULING. Receipt is acknowledged of your letter of July 3, 1917, and in reply you are advised that, as may be seen upon reference to Treasury Decision 2481, the federal income tax law of September 8, 1916, authorizes corporations, joint-stock companies, etc., when making annual income tax returns, to deduct from gross income a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade, and in the case of oil and gas wells and mines, a reasonable allowance for depletion of natural products.

You are further advised that when such deductions are made and their amounts are carried to a reserve account, and later a dividend is declared and paid from that account, the amount of the dividend is held to represent a return of capital invested, and it is not subject to income tax in the hands of the shareholders. (Letter to Henry W. Beal, Boston, signed by Deputy Commissioner L. F. Speer and dated July 14, 1917.)

This ruling was revoked by T. D. 2540 (October 10, 1917).

REGULATION. A distribution from such a reserve will be considered a liquidating dividend and will constitute taxable income to a stockholder only to the extent that the amount so received is in excess of the cost or fair market value as of March 1, 1913, of his shares of stock. . . . . (Reg. 45, Art. 1549.)

and would not be notified that the par value had in effect been reduced. It is most likely that he would report the dividend for taxation with other dividends.

Certain corporations have notified their stockholders that parts of the dividends were from depletion reserves. Stockholders of such corporations may naturally assume that the earned surplus of the corporations has been exhausted and that the dividends are in fact out of depletion reserves. When such dividends are received they should be entered by the recipients as receipts of capital and should not be reported as taxable dividends.

Even though appreciation at March 1, 1913, has not been realized through sale, or through depletion charges,[55] tax-free distributions may be made therefrom, provided, of course, earnings since March 1, 1913, have all been distributed.

Dividends paid from depletion reserve based on discovery value.—There appears to be no specific ruling of the Treasury regarding the taxability in the hands of the stockholder of a dividend from depletion reserve based on discovery value, under either the 1918 or 1921 laws. The provision permitting the deduction for depletion to be based on the "fair market value of the property at the date of discovery, or within 30 days thereafter," in the case of mines, oil and gas wells discovered by the taxpayer on and after March 1, 1913, is first found in section 214 (a-10) of the 1918 law. This provision was re-enacted in the 1921 law. The Treasury under the 1918 law (C. B. 3, page 44, Sol. Op. 26) held that in computing the gain or loss from the sale of mines, oil and gas wells discovered on or after March 1, 1913, "the taxpayer is not entitled to set up the value as of the date of the discovery or within 30 days thereafter, as a basis of the computation." In that ruling it was held that section 202 of the 1918 law fixes the basis for determining gain or loss from sale of property as the fair market value of such property as of March 1, 1913,

[55] See pages 731-737.

if acquired prior thereto, and as cost, if acquired subsequent to that date, and that it contains no exception. It was held, on the other hand, that depletion pertains to operation and not to sale and that section 214 (a-10) "provides only for *the return of capital* pro rata with the actual depletion of the mine or well. The express language of paragraph 10 above quoted is that 'the *depletion allowance* shall be based upon the fair market value of the property at the date of the discovery or within 30 days thereafter.' "

In support of this conclusion the Solicitor also quotes section 211 (d) of the 1918 law limiting the surtax on sale to 20 per cent of the selling price, and section 337 limiting the excess profits tax to 20 per cent of the selling price, and says: "The clear purpose of these provisions is to relieve the hardship which would be imposed upon the taxpayer if not only the normal tax, imposed by section 210 of the Act, but also the surtax and profits tax were assessed upon the basis of the entire gain." He makes a further point that if the taxpayer were permitted to use the discovery value instead of the cost basis in computing gain on sale of the property, "it is difficult to imagine a case where such relief would be necessary or where in fact the provision for limiting the tax to not exceed 20 per cent of the selling price would be applicable."

The Treasury also recognizes that there is in such case "a discrimination in favor of the discoverer who operates and against the discoverer who sells." But "in permitting the taxpayer *to recover as capital* a value which he has neither created nor purchased, the Congress, in effect, has conferred upon him a bounty, and it was at liberty to affix such conditions and limitations to that bounty as it saw fit."

It is further stated that "the only doubt in this case appears to have arisen out of the following language in Advisory Tax Board Recommendation 4 'the amount recoverable by a taxpayer without liability to tax under the war revenue act of 1918, either by way of deduction for depletion *or of the return of capital upon the sale of the property,* is the cost of

the property, fair market value as at March 1, 1913, or within 30 days after discovery.' " The Treasury goes on then to say that "the statement as to the amount recoverable by the taxpayer as return of capital *upon the sale of property* is not supported by the reasoning of the recommendation and is clearly dictum." It holds this is so because the only question before the Treasury when Recommendation No. 4 was made was whether "depletion which has or should have been taken to date" meant "depletion actually allowed by the earlier income tax law in computing net income or the depletion actually sustained whether or not all of such amount was deductable in computing net income under such laws." From the foregoing it would appear that while the Treasury has looked upon the annual depletion allowances to the discoverer as a return of capital, it finds no difficulty in setting aside the view that the discovery value is the capital value to which the discoverer is entitled, if he decides to obtain such value by selling the property rather than operating it to the end of its useful life.

In determining the "earnings or profits accumulated since February 28, 1913," the corporation's depletion based on discovery value is deducted from gross income and credited to reserve for depletion. Some authorities hold that any distribution from such depletion reserve is a return of capital, and therefore non-taxable to the recipient stockholders.

There are others who do not go as far as this, but who maintain that such distributions are of capital not subject to normal tax and surtax, but only to the 12½ per cent capital gain tax to the extent that such a distribution exceeds the cost of the stock. In other words, they rely on section 201 (c) of the 1921 law which provides that any distribution "otherwise than out of (1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, shall be applied against and reduce the basis, provided in Section 202, for the purpose of ascertaining the gains

arrived or loss sustained from the sale or other dispositions of stock or shares by the distributee."

The intent of the law has been stated as follows:

> It was plainly the intention to broaden and clarify the existing law by providing that all distributions by corporations, save those out of (1) earnings since February 28, 1913; or (2) earnings prior to March 1, 1913, or (3) increase in value of property prior to March 1, 1913, *shall be capital distributions to the stockholder.*[56]

Another argument offered in support of the claim that the allowance made by Congress is not in the nature of a bounty but rather in the nature of recognizing as *capital* the discovery allowance to be returned to the taxpayer, has been stated as follows:

> Among the most characteristic qualities of the oil, gas and mining industry, is, not only its wasting character, but that it lived and had its being by continuous discoveries of new ore bodies and oil wells. All successful mining operations were based at some time in their history upon a discovery.
>
> In the hunt for new mines the industry, through the prospector or the miner, wasted untold and unrecorded sums and effort. These, though unrecognized, represented the capital cost of the final discovery. They were properly chargeable against the successful enterprise that finally found the ore body or oil well. In large measure, its excess value over the actual recorded cost of the particular discovery, represented this unrecorded capital expenditure made in attempting to find ores in other directions that came to naught. *It was but just, therefore, that in recognition of this fact the excess discovery value should be capitalized and, for income tax purposes, treated as capital.*
>
> Congress therefore granted the allowance to the discoverer not as a special exemption but in the form of *a depletion allowance based upon the discovery value* as fairly representative of the capital investment.
>
> The granting of this, by way of *depletion on the discovery value,* was the clear expression by Congress that this discovery value represented the capital assets of the taxpayer, to be treated for income tax purposes the same as the capital of the mine owner who had paid cash for his mine.[57]

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[56] *Distributions from the Depletion Reserve,* by Paul Armitage (address delivered at American Mining Congress, Cleveland, Ohio, October, 1922, page 38).

[57] *Ibid.,* page 42.

The author is not convinced that Congress intended to free such dividends from the surtax. The provision was effective when other corporations were paying the 80 per cent tax on "excess" profits. That should have been a sufficient differential. Of course, if the law can reasonably be construed to free dividends from discovery depletion reserves from the surtax and possibly from any tax at all, taxpayers are justified in claiming the benefits of such tax exemption.

Dividends paid out of appreciation of goodwill.—The author does not care to assume that cash dividends would ever be paid out of surplus arising from appreciation in the value of goodwill or other capital assets. But since stock dividends are sometimes paid out of marked-up assets, no doubt some corporations will attempt to pay cash dividends from the same source.[58] If the stockholder were to receive a dividend accompanied by a notice from the corporation that it was in fact from surplus so created the stockholder should enter the dividend as free from tax. Appreciation accrued after March 1, 1913, is taxable when realized, but in the case cited it should be specifically stated that realization had not taken place. The dividend, in fact, would be out of capital and would not be taxable. The stockholder would be entitled to assume that the earned surplus of the corporation had been exhausted.

Dividends from capital surplus.—The regulations are clear that no tax will be imposed upon a dividend paid from capital surplus.[59] Capital surplus may arise through the payment (in either cash or property) by stockholders of an amount in excess of the par value of capital stock, through the creation of shares of "no par" value and in other ways.

It is sometimes claimed that distributions similar to the foregoing may be made at any time, irrespective of whether or not the surplus earned since March 1, 1913, has been distributed.

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[58] See Chapter XXVIII, "Stock Dividends."
[59] Art. 1543, page 713.

Obviously the distribution of capital dividends diminishes the assets of a corporation to exactly the same extent as when a distribution of earnings is made. This question then arises: Is a provision of law enforceable which forbids any distribution until the surplus earned since March 1, 1913, has first been entirely distributed? Section 201 (b) reads:

LAW. Section 201. . . . . (b) . . . . every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913; but any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed. . . .

The author is of the opinion that this provision of the law is enforceable except when the distributions consist of payments required by the reduction or cancellation of capital stock.

When a corporation reduces its capital stock, state corporation laws require that the stock certificates shall be canceled or stamped, and it would be illegal for a corporation to advise its stockholders that payments in reduction or retirement of capital stock should be deemed to be dividends out of recent earnings, merely because of a federal law which attempts to require a distribution of current earnings before previous earnings are distributed.

As a matter of fact the payments in reduction of capital stock may be made to only one of several classes of stockholders. In many cases the obligations to retire preferred stock[60] are contractual and the payments must be made if the corporations are in funds. This view has been accepted by the Treasury.

RULING. The term "distribution" as used in Section 201 (*b*) of the Act means the delivery or transfer of property by a corporation to its stockholders. Whether any distribution by a corporation

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[60] For discussion of redemption of stock held to be equivalent of a cash dividend [section 201 (d)], see page 0000.

is to be deemed to have been made from earnings or profits depends upon the facts in each case. However, the term "distribution" as used in Section 201 (*b*) of the statute does not contemplate the payments made by a corporation to its stockholders in retiring its own stock if the liquidation of the stock was in pursuance of an obligation arising out of the stock contract, unless it appears that the corporation had the option of distributing its assets with a credit to capital stock account or to surplus account. However, inasmuch as a retirement of capital stock would indicate that additional capital was not required, any retirement of common stock, leaving the surplus stand, would be regarded by this office as making the corporation one coming within the provisions of Section 220 of the Revenue Act of 1918.[61] (C. B. 2, page 25; O. D. 360.)

The foregoing rule may not be applicable when the distribution to stockholders consists of the return by a corporation of a special or temporary assessment on its stockholders which is specifically returned when the emergency is over. Nor is it applicable unless the purchase or retirement is pro rata to all common stockholders. Many corporations acquire odd lots from estates, from employees who are no longer connected with the corporation and for similar corporate purposes. Such payments to some of the corporation's stockholders, if made in good faith, cannot be considered to be such a distribution as to bring it into the category of taxable dividends.

Liquidating Dividends

The 1921 law makes no specific reference to distributions in liquidation. Section 201 (c) of the 1918 law which provided that "amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock," appeared in the House draft of the 1921 law but was stricken out in the Senate.[62] The new subsection (c) which was inserted in conference reads:

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[61] See Chapter XL, "Tax on Undistributed Profits of Corporations."

[62] **[Former Procedure]** The 1918 law contained this specific provision:

LAW. Section 201. . . . . (c) Amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or

Law. Section 201. . . . . **(c) Any distribution (whether in cash or other property) made by a corporation to its shareholders or members otherwise than out of (1) earnings or profits accumulated**

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shares and any gain or profit realized thereby shall be taxed to the distributee as other gains or losses. . . . .

It was the duty of the directors to distribute the assets in such a way that all earnings subsequent to March 1, 1913, would first be distributed formally as dividends. Distributions of surplus and appreciation at March 1, 1913, should have been made before finally returning the capital. The last noted distribution was taxable or not taxable under section 201 (c) and article 1544.

In the opinion of the author, the section quoted was intended to set up an equitable basis for the taxation of distributions in liquidation. It was not intended as a substitute for the sections which governed the distributions of earnings accumulated since March 1, 1913. It was not intended as a penalty clause nor as imposing double taxation. The Treasury, however, construed it as an inclusive pronouncement that in connection with the liquidation of a corporation there could be no such thing as a dividend, the entire distribution including profits accrued since March 1, 1913, being applied against cost and the gain taxed at both normal and surtax rates. (See Reg. 45, Art. 1548, and C. B. 3, page 40; Digest A. R. M. 93.) Later the Treasury reversed its position and ruled that only the "return of capital" was to be applied against the cost and that distributions of earnings after March 1, 1913, were to be considered dividends, subject only to the surtax rates. (C. B. 4, page 44; O. D. 955.) Finally it reverted to its original position. (C. B. 5, page 47; Sol. Op. 115.) For a full discussion see *Income Tax Procedure,* 1922, pages 751-755.

As the 1918 law is the only one which contains any reference to distributions in liquidation, as distinguished from any other kind of distribution, we are compelled under the 1913, 1916, 1917 laws, as well as under the 1921 law, to depend on the laws themselves for guidance. In the 1917 law there was a clearly defined method prescribed for all ordinary and extraordinary dividends. When a corporation was dissolved and its assets were distributed, they were taxable as dividends or as gains, depending on circumstances. In the absence of special statutes, words must be given their usual significance. Therefore the use of the word "dividends" in 1917 and prior laws included dividends in dissolution or liquidation as well as ordinary dividends.

The excess profits tax law of 1917 provided that income should be determined as for income tax purposes which included in gross income amounts received as dividends upon the stock or from the net earnings of other corporations. For the excess profits tax computation it was provided that such dividends should be deducted from gross income. The Treasury attempted to hold that liquidating dividends were not "dividends," and that such income was subject to excess profits tax. The effect was

since February 28, 1913, or (2) earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, shall be applied against and reduce the basis provided in section 202 for the purpose of ascertaining the gain derived or the loss sustained from the sale or other disposition of the stock or shares by the distributee. . . .

Whatever the reason for eliminating specific reference to the liquidation of a corporation, it is clear from the foregoing section of the 1921 law that *any* distribution out of earnings accumulated since March 1, 1913, is a dividend.

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so absurd that the Treasury abandoned its contention, although the following ruling does not admit it.

RULING. . . . . Liquidation or dissolution dividends are not treated as ordinary dividends within the meaning of the Revenue Act of 1916, as amended by the Revenue Act of 1917. (*Lynch v. Turrish,* 247 U. S. 221.) They are regarded as a purchase of shares, and any excess received by a stockholder over the cost of the stock constitutes income to such stockholder. (C. B. I-1, page 18; Sol. Op. 131.)

It is significant to note that the Solicitor does not advance any argument in support of his position, and that *Lynch v. Turrish* (247 U. S. 221, 38 Sup. Ct. 537, 62 L. Ed. 1087) is the only authority cited. In the author's opinion the Solicitor's ruling is unsound and is not supported by *Lynch v. Turrish* or any decided case or by common sense.

The Supreme Court of the United States decided *Lynch v. Turrish* (*supra*) and *Lynch v. Hornby* (247 U. S. 339, 38 Sup. Ct. 543, 62 L. Ed. 1149) the same day, June 3, 1918. The Solicitor does not quote statements from the *Turrish* case in support of his position. In the *Turrish* case the court held that a dividend in dissolution was not taxable; and in the *Hornby* case the court decided that a dividend was taxable. In both cases the dividends were from earnings or gains accumulated prior to March 1, 1913. In the *Turrish* case, even though there was a final and complete distribution, the court always referred to the distribution as a dividend. The Commissioner assessed the tax on the theory that it was "a dividend received from a domestic corporation" and taxable as an ordinary dividend. The court held that no taxable income arose from the receipt of the dividend. Reference was made to the fact that a stockholder has no title to the property of a corporation "prior to a dividend being declared." It should be remembered that in the *Turrish* case the court had but one quesiton before it: viz., was the appreciated March 1, 1913, value of certain stock held by another corporation, taxable when distributed to stockholders upon liquidation? In other words, is a taxpayer entitled to a tax-free return of his capital which existed as of March 1, 1913?

It is obvious that prior to the enactment of the 1918 law no one questioned the fact that a dividend in liquidation was a "dividend." There were

If not clear in subsection (c), there is nothing ambiguous in subsection (a) which provides that the term dividend "means any distribution made in cash or in other property, out of its earnings or profits accumulated since February 28, 1913." It is probable that the narrow construction placed by the Treasury upon section 201 (c) of the 1918 law is responsible for the change. That section was construed to mean that the credit for normal tax could not be taken in distributions in liquidation.[63] In the author's opinion the 1918 law did not so state and there certainly was no intention to deprive stockholders of the credit.

Distributions in liquidation which are dividends.—As heretofore stated, dividends include *any* distribution out of earnings accumulated since March 1, 1913. There is not a

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serious questions regarding the taxable status of values at March 1, 1913, and the position of stockholders who purchase at a high price and who might pay excessive taxes upon a dividend in partial liquidation. But these questions never arose regarding the distribution of earnings accumulated *since* March 1, 1913. In the case of new stockholders who pay excessive taxes on partial liquidations, *because they are deemed to be ordinary dividends,* the United States Supreme Court in the case of *United States v. Phellis* (advance opinions, 66 L. Ed. —, 42 Sup. Ct. 63) said:

Decision. The possibility of occasional instances of apparent hardship in the incidence of the tax may be conceded. Where, as in this case, the dividend constitutes a distribution of profits accumulated during an extended period, and bears a large proportion to the par value of the stock, if an investor happened to buy stock shortly before the dividend, paying a price enhanced by an estimate of the capital plus the surplus of the company, and after distribution of the surplus, with corresponding reduction in the intrinsic and market value of the shares, he were called upon to pay a tax upon the dividend received, it might look in his case like a tax upon his capital. But it is only apparently so. In buying at a price that reflected the accumulated profits, he, of course, acquired as a part of the valuable rights purchased the prospect of a dividend from the accumulations—bought "dividend on," as the phrase goes—and necessarily took subject to the burden of the income tax proper to be assessed against him by reason of the dividend if and when made. He simply stepped into the shoes, in this as in other respects, of the stockholder whose shares he acquired, and presumably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon. In short, the question whether a dividend made out of company profits constitutes income of the stockholder is not affected by antecedent transfers of the stock from hand to hand.

[63] See page 743.

word in any section of the law which contradicts this statement in section 201 (a). A distribution may be final or partial. The section contemplates final distributions in its reference to distributions in property other than cash.

Regulation. Where a corporation distributes all of its property in complete liquidation or dissolution, the gain realized by the stockholder from the transaction, computed under section 202, is taxable as a dividend to the extent that it is paid out of earnings or profits of the corporation accumulated since February 28, 1913. If the amount received by the stockholder in liquidation is less than the cost or other basis of the stock, a deductible loss is sustained. (Art. 1545.)

Therefore, the right to credit the normal tax is perfectly clear.

In computing excess profits tax in 1917 the Treasury held that liquidation dividends were dividends, and could be "credited" as ordinary dividends.

Taxable status of liquidation dividends.—The term "dividend" as used in section 201 (a) may be limited to distributions made from earnings accumulated since February 28, 1913. Corporations have paid the normal tax on these earnings. Stockholders are liable for the surtax.

Distributions which are not dividends.—In view of the limitation on the term "dividend" in section 201 (a), it is obvious that all distributions, otherwise than out of earnings accumulated since March 1, 1913, are returns of capital, either taxable or not taxable according to their nature.

Regulation. Any distribution made by a corporation to its stockholders otherwise than out of (1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, is not a dividend and is not taxable to the recipient. Any such distribution, however, shall be applied against and reduce the cost, or other basis, of the stock upon which declared, for the purpose of determining the gain or loss from the subsequent sale of the stock.

Example.—A purchased certain stock in 1915 for $10,000 and received in 1921 a distribution thereon of $2,000 paid by the corporation otherwise than out of its earnings or profits or the increase in value of

property accrued prior to March 1, 1913. This distribution does not constitute taxable income to A. If A subsequently sells the stock the difference between the amount realized therefor and $8,000 is taxable gain or deductible loss, as the case may be. (Art. 1544.)

The foregoing regulation properly intimates that distributions out of earnings accumulated since March 1, 1913, are dividends. It also intimates that distributions out of earnings or increase in value of property accrued prior to March 1, 1913, may be dividends. As the latter distributions are not taxable in any event, it should be immaterial how they are designated. The stipulation that distributions which are not dividends shall be applied to reduce the cost, or March 1, 1913, value, of the stock upon which declared is proper.[64] It is equivalent to stating that such cost or value shall be reduced by the receipt of any distribution of capital which the corporation may make.

In a recent opinion dealing with stock dividends,[65] the Solicitor quotes in support of his contention (that a stock dividend is not a distribution) a decision of the Supreme Court of the United States wherein "a distribution was defined to mean 'that portion of its profits which the corporation, by its directorate, sets apart for ratable division among its shareholders.' "[66]

Taxable status of distributions which are not dividends.—Naturally any distributions of capital are free from normal or surtaxes, unless and until there is a taxable net gain, in which case the gain is taxable as any other net gain, viz., if the stock has been held for more than two years the maximum tax is 12½ per cent;[67] if held for less than two years the gain is subject to the full surtax rates.

Dividends Received by Corporations

The 1921 law has two features in respect of dividends received by corporations which differ from preceding laws.

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[64] For illustrations see Chapter XXII.

[65] I-40-529; Sol. Op. 144.

[66] *Mobile & Ohio R. R. v. Tennessee*, 153 U. S. 486, 14 Sup. Ct. 968, 38 L. Ed. 793.

[67] See page 624 *et seq.*

LAW. Section 234. (a) That in computing the net income . . . . there shall be allowed as deductions: . . . .

(6) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, and other than a corporation organized under the China Trade Act, 1922, or (B) from any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under section 217; . . . .

This provision imposes no tax on dividends received by one corporation from another corporation unless received from

(a) A domestic corporation receiving most of its income from within a possession of the United States.

(b) A foreign corporation deriving 50 per cent or more of its income from without the United States under certain conditions.[68]

(c) A corporation organized under the China Trade Act, 1922.[69]

Dividends other than (a), (b) and (c) are to be included in gross income, but the full amount may be deducted in ascertaining net income.

Under an income tax law of the type of the federal law it is not equitable to impose tax on dividends received by a corporation, because the normal tax has already been paid on the earnings so distributed. Furthermore, when a corporation, which has received dividends, in turn pays out its own net income in dividends, the recipients (if individuals) are subject to the surtax. Therefore, any income tax assessed against dividends received by corporations is double taxation. The 1913, 1916 and 1917 laws all imposed expressly or by

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[68] Section 234 (a-6).

[69] See section 245 (a-3), as amended by section 27 of the China Trade Act.

implication full or partial income taxes upon dividends received by corporations, but the 1918 law granted full credit for dividends received in determining the taxes payable by the receiving corporation.[70]

The 1921 law has placed a limitation on the full credit [section 234 (a-6)].

Dividends (received by corporations) which are not taxable.—Under the 1916, 1917, 1918 and 1921 laws, dividends payable out of surplus accrued prior to March 1, 1913, are not taxable. This provision applies to corporations as well as to individuals.[71]

Under the 1913 law, the Supreme Court has held that dividends received prior to December 31, 1915, are taxable even though paid out of surplus accrued prior to March 1, 1913,[72] but in a specific case an exception was made to the rule.[73] The departure from the rule was justified by the court on the ground that the holding company was in actual possession and control of the funds represented by dividends prior to March 1, 1913, and that the declaration of the dividends after March 1, 1913, merely resulted in bookkeeping entries, there being no transfer of cash or property nor in fact any change in actual status. As stated by the court, "the payment was only constructive."

In a later case[74] the Supreme Court again decided that a dividend paid out of surplus accrued prior to March 1, 1913, was not taxable, on the ground "that the transaction should be regarded as bookkeeping rather than as dividends declared and paid in the ordinary course by a corporation."

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[70] **[Former Procedure]** For regulations and procedure under former laws see *Income Tax Procedure*, 1919, pages 344-347.

[71] Section 201 (a).

[72] *Lynch v. Hornby*, 247 U. S. 339, 38 Sup. Ct. 543, 62 L. Ed. 1149.

[73] *Southern Pacific Company v. Lowe*, 247 U. S. 330, 38 Sup. Ct. 540, 62 L. Ed. 1142.

[74] *Gulf Oil Corporation v. Lewellyn*, 248 U. S. 71, 39 Sup. Ct. 35, 63 L. Ed. 133. See also *Park v. Gilligan*, U. S. Dist. Ct., So. Dist. of Ohio, West. Div., June 11, 1921 (1916 Act).

A holding company acquired all of the stock of a subsidiary. The subsidiary then paid its entire surplus to the holding company as a dividend. The Treasury held:

Ruling. A cash dividend paid in 1916 by a subsidiary to parent corporation, its sole stockholder, is taxable under the Revenue Act of 1916 to the extent that such dividend was paid from surplus earned after March 1, 1913 (1916 law only). (C. B. 1, page 19; Digest T. B. R. 45.)

Miscellaneous

Deferred dividends and redemption of preferred stock.—

Ruling. In 1919 a corporation paid three deferred dividends on its outstanding issue of first preferred stock and at the same time redeemed the entire issue of such stock at a premium of 12½ per cent. It is stated that the dividends so paid were those due February 1 and August 1, 1910, and February 1, 1911; that the actual surplus necessary to pay them was accumulated prior to December 31, 1911; that there had not been any actual declaration of these dividends prior to 1919 for the reason that the terms of issue of the stock prescribed when the dividends became due, the company merely having the privilege of deferring payment and that it was the understanding of the officers of the company that its surplus was held to pay past due dividends. The stock certificates contained a provision in accordance with which the deferred dividends were paid and the stock redeemed.

The three deferred dividends will be considered to have been paid out of earnings and profits accumulated since February 28, 1913, as provided for in section 201 (a) and (b), Revenue Act of 1918, unless it can be shown that all earnings and profits accumulated since that date were first distributed. If it can not be shown that the earnings and profits accumulated since February 28, 1913, were first distributed, the distribution constitutes income to the recipient stockholders subject to additional tax at the graduated rates, but not to the normal tax.

The payment in redemption of the stock was a distribution in part liquidation of the corporation within the meaning of section 201 (c), and not a dividend as defined in section 201 (a) of the act. The amount received by each stockholder in excess of the cost of his shares of stock to him or their fair market value as of March 1, 1913, if acquired prior to that date, represented taxable income to him, subject to both normal and additional tax. (C. B. 2, page 29; O. D. 488.)

The last paragraph of the foregoing ruling is probably unsound under the 1918 law[75] and would not be applicable under the 1921 law. Assume that a corporation has:

Common stock	$150,000
Preferred stock	100,000
Surplus (accumulated since March 1, 1913)	80,000

Assume further, that in 1921 the entire preferred stock was redeemed at a premium of 12½ per cent. The charge to surplus would be $12,500, as distribution from "earnings or profits accumulated since February 28, 1913"; thus coming within the definition of a "dividend"[76] which is exempt from normal tax.

Premiums received from a corporation on its capital stock are equivalent of dividends.—Many issues of preferred stocks contain provisions compelling the retirement or purchase thereof by the issuing corporations at substantial premiums above par value. When corporations acquire shares of their capital stock in this manner the payments must be charged to surplus and cannot be treated as allowable deductions. The payments are clearly distributions of surplus or profits[77] and the normal income tax having been paid thereon by the corporations, the stockholders are not required again to pay the normal tax.

In reporting premiums for income tax purposes stockholders should enter the amounts precisely as if a dividend had been received. However, if the earned surplus were not sufficient to pay the premiums, and the funds were derived from capital surplus or from gifts to the corporation by holders of common stock, the recipients could not claim credit for the normal tax. In the absence of advices to the contrary it may be assumed that the premiums represent a distribution

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[75] See page 740, footnote 62.
[76] Section 201 (b). See page 738.
[77] The term "dividend" means any distribution made by a corporation out of its earnings or profits. [1921 law, section 201 (a).]

of earnings. Corporations which have no surplus are rarely able to carry out the redemption provisions of a preferred stock issue.

Under the 1921 law such distributions are clearly dividends.[78]

Dividends on life insurance policies.—So-called dividends declared by life insurance companies on certain classes of unmatured policies are in fact reductions of premiums and are not taxable. As a rule policyholders deduct the amounts of such so-called dividends from the premiums payable, but even if dividends are drawn in cash by the insured, such items, unless received on paid-up policies, do not constitute taxable income and should be excluded from returns.

REGULATION. . . . . Distribution on paid-up policies which are made out of earnings of the insurance company subject to tax are in the nature of corporate dividends and are income of an individual only for the purpose of the surtax. (Art. 47.)

DIVIDENDS ON TONTINE POLICIES.—

RULING. A taxpayer took out an insurance policy on the tontine plan in 1902 and in 1917 received the total accumulated dividends. The face value of the policy will be paid to him in 1922, if living.

Held, that the amount received in 1917 was not required to be reported as income for that year. The excess of the amount received at maturity of the policy plus all dividends received thereon, over the total premiums paid prior to March 1, 1913, or the cash surrender value of the policy as of that date, whichever is greater, plus the premiums paid subsequent to March 1, 1913, will represent taxable income to be reported for the year in which received for both normal and additional tax purposes. (C. B. 2, page 85; O. D. 490.)

So-called dividends which are in fact refunds are not taxable.—The word "dividend" is often carelessly used. Therefore, the recipient of a dividend (or what purports to be a dividend) from an unusual source should ascertain the source from which it is derived before returning it for taxation. The income tax is not imposed on refunds which are merely repayments of excessive prices paid for goods purchased, etc.

[78] C. B. 2, page 29; O. D. 488. See page 747.

REGULATION. . . . . rebates made to purchasers, whether or not members of the association, in proportion to their purchases may be excluded from gross income in computing the net income subject to tax. Any profits made from non-members and distributed to members in the guise of rebates are, of course, subject to tax. (Reg. 45, Art. 522.)

Dividends in kind.—Article 1570 states that when a partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property. No mention is made of "dividends in kind" by corporations.[79]

A dividend in kind, generally speaking, means a distribution of assets which cannot readily be turned into money, or which the stockholders or directors do not desire to turn into money.

A stock dividend is not a dividend in kind. When a corporation distributes to its stockholders the stock of another company it is a dividend in kind. If the stock so distributed has a fair market value the dividend is taxable. If it does not have a fair market value it is not taxable until realized.

There have been some so-called distributions in kind which should be held to be taxable.

A corporation sells its capital assets for cash, invests the proceeds in marketable securities and divides the securities among its stockholders. This is simply a dividend payable in securities and is taxable,[80] even though, technically, it is a dividend in kind.

A corporation buys a plot of land and holds it for some years. No sales are made and no fair market price is ascertainable. The corporation dissolves and conveys the land pro rata to its stockholders. This is a distribution in kind and no tax can be imposed until the stockholders dispose of their holdings, in whole or in part.

The foregoing illustrations are clear cases—one im-

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[79] [Former Procedure] Art. 1566, Reg. 45 (April 17, 1919 edition), provided for distributions in kind by corporations but the provision was eliminated by T. D. 2924 (September 26, 1919).

[80] See page 723.

mediately taxable and the other not. Between the two there are cases not so easy to decide. Whether or not the dividend is presently taxable depends largely on two factors: (1) When were the assets divided in kind acquired? (2) Is there any fair market value for the assets distributed?

Dividends on stock of federal reserve banks exempt from both normal and surtaxes.—See page 385. It should be noted that the exemption of dividends received by member banks does not extend to dividends paid on the stock of member banks.

Owners of record liable for tax—exception.—Many stocks are owned by others than shareholders of record. In such cases the following regulation is of importance:[81]

> REGULATION. Dividends on stock of domestic corporations or resident foreign corporations are prima facie income of the record owner of the stock, and such record owner will be liable for any additional tax based thereon, unless a disclosure of the actual ownership is made to the Commissioner on Form 1087 which shall show that the record owner is not the actual owner and who the owner is and his address. In all cases where the actual owner is a nonresident alien individual and the record owner is a person in the United States, the record owner will be considered for tax purposes to have the receipt, custody, control, and disposal of the dividend income and will be required to make return for the actual owner, regardless of the amount of the income, and to pay any surtax found by such return to be due. (Art. 405.)

While this regulation is broad enough to cover all cases, form 1087 is apparently designed for use only by non-resident aliens.

Local taxes paid on bank stocks no longer equivalent of dividends.—In addition to the cash dividends received from banks, the owners of some bank stocks have local taxes paid for their account by the bank. The amount of such payments

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[81] See also Chapter XLI.

is deductible by the bank[82] and does not form constructive income to the stockholder.[83]

RULING. A shareholder of a bank in West Virginia may file with the assessor a claim for exemption from taxation of the stock, which tax is payable by the bank, to the extent of the indebtedness owing by the shareholder on the assessment date. Where the bank pays to the shareholder the amount of the tax which it would have paid for him to the State, such payment is in the nature of an additional dividend to the recipient.

Such an amount may not be deducted from the gross income of the bank under section 234 (a) 3 of the Revenue Act of 1921. . . . . (C. B. I-1, page 11; Digest I. T. 1300.)

Salaries in excess of reasonable or necessary allowances to be treated as dividends.—As to the treatment of amounts ostensibly paid as compensation, the Treasury has issued the following regulation:

REGULATION. . . . . (1) In the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stock holdings, the amount of the excess should be treated as dividends and would thus be exempt from the normal tax in the hands of the recipients. . . . . (Art. 106.)

Before the foregoing regulation can be applied, salaries must be found to be excessive. See Chapter XXI.

Dividends paid to resident citizens of China by corporation created by China Trade Act.—

LAW. Section 213. . . . . "gross income" . . . . (b) does not include the following . . . . which shall be exempt from taxation under this title [income tax]: . . . .

(13) In the case of an individual, amounts distributed as dividends to or for his benefit by a corporation organized under the China Trade Act, 1922, if, at the time of such distribution, he is a citizen of China resident therein and the equitable right to the income of the shares of stock of the corporation is in good faith vested in him.[84]

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[82] Section 234 (a-3).

[83] Section 214 (a-3-d).

[Former Procedure] Under the 1918 and prior laws, taxes assessed on stockholdings and paid by banks on behalf of their stockholders, were considered as additional dividends to such stockholders, the latter in turn entering the taxes as a deduction in their personal returns.

[84] This paragraph was added to the 1921 law by section 26 of the China Trade Act, approved September 19, 1922.

CHAPTER XXVIII

INCOME FROM STOCK DIVIDENDS

In 1920 the Supreme Court of the United States decided finally that stock dividends are not taxable as income.[1] Since the imposition of the federal income tax in 1913, the author had consistently predicted that the Supreme Court would take this position.

There are those who still believe that a benefit accrues to the recipient of a stock dividend. Such people show an utter disregard of the market quotations for stocks before and after stock dividends are declared. In most cases the old shares freely sell higher than the new shares, including the dividend. However, the feeling exists that some sort of a legal tax should be imposed and corporations are on notice that what could not be done directly may be done indirectly. In at least two states stock dividends have been held to be taxable income.[2]

Those who are interested in the various laws, regulations, rulings and court decisions which preceded the handing down of the decision in the *Macomber* case in 1920 will find them discussed in detail in *Income Tax Procedure,* 1917 to 1920, both inclusive.

Procedure of current interest includes the definition of a stock dividend, the computation of gain or loss upon the sale of the old or new stock and the method employed in obtaining credit for or refund of the tax collected before the final decision.

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[1] *Eisner v. Macomber,* 252 U. S. 189, 40 Sup. Ct. 189, 64 L. Ed. 521, March 8, 1920. For full text of decision of court and minority opinion, see Corporation Trust Company 1922 Income Tax Service, supplementary pages 173-186.

[2] *State ex rel. Dulaney v. Nygaard,* 183 N. W. 884, 174 Wisc. 597; *Tax Commissioner v. Putnam,* 227 Mass. 522, 116 N. E. 904, L. R. A. 1917 F. 806.

The 1921 law contains the following section dealing with stock dividends:

LAW. Section 201. . . . . (d) **A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend to the extent of the earnings or profits accumulated by such corporation after February 28, 1913. . . . .**

This section is reasonable. It would be unfortunate if a tax-exempt distribution, the equivalent of cash, could be made indirectly, whereas a direct distribution would be taxable. In providing that the proceeds of redemption of stock dividends shall be treated as dividends instead of as the proceeds of sales of stock, the law now recognizes the principle that the proceeds of the sale or redemption of stock dividends are free from the normal tax,[3] to the extent that the dividend represents a charge against surplus accrued since February 28, 1913.

What Is a Stock Dividend?

A stock dividend is a dividend declared by a corporation payable in stock of the same corporation. Uncertainty regarding stock dividends still exists.[4] Some conceive the term to include a dividend payable in the stock of other corporations which is clearly an erroneous view. Some hold that a dividend on common stock payable in preferred stock is not a true stock dividend. This contention may have some merit, but the author is of the opinion that a dividend payable in any class of stock of the same corporation is not taxable.

In the case of *Loomis v. Wattles,*[5] the Circuit Court of

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[3] See page 763.

[4] See hearings before the Committee on Ways and Means, House of Representatives, March 18 and 19, 1920, page 38 *et seq.* The question as to whether a stock dividend can legally be declared in the state of Missouri has been decided in the affirmative. (C. B. 4, page 24; O. D. 887.)

[5] 266 Fed. 876.

Appeals for the Eighth Circuit held that after a collector has assessed a tax on the basis of a stock dividend, he cannot be heard in court to say that it was a cash dividend.

Ordinary stock dividend defined.—

RULING. . . . . 1. Where a corporation, being authorized so to do by the laws of the State in which it is incorporated, transfers a portion of its surplus to capital account, issues new stock representing the amount of the surplus so transferred, and distributes the stock so issued to its stockholders, such stock is not income to the stockholders and the stockholders incur no liability for income tax by reason of its receipt. . . . . (C. B. 3, page 38; T. D. 3052.)

Cash dividend with option or agreement to buy stock.— Important problems arise in the attempt to distinguish true stock dividends from those which involve a distribution of cash in some form.

RULING. . . . . 2. Where a corporation, being thereunto lawfully authorized, increases its capital stock, and simultaneously declares a cash dividend equal in amount to the increase in its capital stock, and gives to its stockholders a real option either to keep the money for their own or to reinvest it in the new shares, such dividend is a cash dividend and is income to the stockholders whether they reinvest it in the new shares or not.

3. Where a corporation, which is not permitted under the laws of the State in which it is incorporated to issue a stock dividend, increases its capital stock and at the same time declares a cash dividend under an agreement with the stockholders to reinvest the money so received in the new issue of capital stock, such dividend is subject to tax as income to the stockholder. . . . . (C. B. 3, page 38; T. D. 3052.)

The foregoing ruling is not sustained by the following:

DECISION.[6] The sole question in this case is whether the dividend received by the defendant from the Gulf Oil Corporation in 1913, constituted taxable income within the meaning of the Act of Congress. If it be a stock dividend, then the plaintiff cannot recover, for the Supreme Court in *Towne vs. Eisner*, 245 U. S. 424, has held that a dividend received by the stockholder in shares of stock of the cor-

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[6] *Lewellyn v. Mellon*, 279 Fed. 910; affirmed by U. S. Cir. Ct. of App. for the 3rd Dist., 281 Fed. 645.

poration, was not income within the meaning of the Act of 1913. It is clear that if the resolution declaring the dividend in question, had provided for the payment of the dividend in stock, the dividend would not have been taxable. It is also clear that the defendant received payment of the dividend in shares of stock, and that he did this pursuant to an agreement made prior to the declaration of the dividend, which agreement was communicated to the corporation before that declaration was made. It is clear that out of 112,080 shares, the holders of all but 1,740 shares actually accepted payment of the dividend in stock, and that the money to pay cash to the holders of said 1,740 shares was provided by T. Mellon & Sons pursuant to an agreement made before the declaration of the dividend, that they would take and pay for any such shares as the holders might refuse to accept as payment therefor. After the transaction, the defendant had two shares to represent the interest in the same property, which prior thereto was represented by one. After the transaction, there were twice as many shares of the corporation in the hands of stockholders as there were before. The corporate assets had not been diminished by the transaction. Therefore, for two shares which defendant possessed at the close, there was for him the same value as for one share represented at the beginning. . . . . In every view of the transaction, we find that its substance is clear. In cases like the present, substance is controlling, and not form. The courts look through all forms of corporate transactions, and have regard to the substance. *Southern Pacific Co. vs. Lowe*, 247 U. S. 330; *Gulf Oil Corporation vs. Lewellyn*, 248 U. S. 71 . . . . the Government urged upon the Court the necessity of observing the form, not in so many words but by their brief filed. They insist that the dividend was a cash dividend, because the resolution of the Board so stated. By implication, therefore, they would place the defendant in the position of having the right to use the check of the corporation, which as a matter of fact, never came into his hands, and which as a matter of fact, must have been drawn against "no funds," notwithstanding his agreement with his associates and with T. Mellon & Sons, and notwithstanding the important fact that without such agreements the resolution of the Board would never have been passed. That the Board would never have passed such resolution if there had been no such agreement, seems clear, not only from the testimony of the witnesses to that effect, but from other facts which appear in evidence, as, for instance, the absence of sufficient money and the limited credit possessed by the corporation, whose obligations to banks were given high standing by the endorsement of some of the very men who entered into the said agreement. In every aspect of this case, the defendant was not in the position where he was merely entitled to carry out his agreement, but he was bound to do so. The dividend in question seems to be a final step in a series of transactions having for their object the refinancing of the corporation, and

was based upon earnings and accumulations by subsidiary companies through a period of years.

Stock dividends may be declared by national banks.—

RULING. You state that the Comptroller of the Currency has held recently that national banks may issue stock dividends and enclose with your letter a copy of a previous holding of the Government in connection therewith.

It is understood that the "Instructions of the Comptroller of the Currency Relative to the Organization and Powers of National Banks" for 1919, in reference to dividends have not been formally modified, nor has any general authority been issued by the Comptroller authorizing national banks to increase their capital stock by declaring stock dividends. It is also understood, however, that the Comptroller has, in some instances, upon the application of a national bank in due form and upon complying with the requirements prescribed in connection therewith by the Comptroller issued his certificate approving the increase of the bank's capital stock, the papers submitted in connection with the application for such increase indicating that it was to be increased by the declaration of stock dividends.

You are advised, therefore, in reply to your inquiry, that if a stock dividend is declared by a national bank in the manner and form prescribed by the Comptroller of the Currency and his certificate of approval issues for the increase of the capital stock of the bank pursuant to its application made in due form for such increase by the declaration of a stock dividend, such dividend is, for income tax purposes, a stock dividend within the meaning of Section 201 (d) of the Revenue Act of 1921, and is therefore not taxable to the recipient. (Letter to The Corporation Trust Company, signed by Commissioner D. H. Blair, and dated April 8, 1922.)

The foregoing ruling differs from a prior ruling which conveyed the impression that national banks are strictly forbidden to declare stock dividends.[7]

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[7] **[Former Procedure]**

RULING. In view of the fact that national banks are authorized by law to issue only cash dividends (see "Instructions of the Comptroller of the Currency Relative to the Organization and Powers of National Banks" for 1919, p. 56) such dividends, coupled with the right to apply same to the purchase of an increase in capital stock, are not within the decision of the Supreme Court in the *Eisner v. Macomber* case and are taxable income to the stockholder for surtax purposes. (C. B. 3, page 24; O. D. 588.)

If one national bank has been permitted to declare a stock dividend, others may do so. The foregoing ruling, therefore, is obsolete.

Stock dividend from surplus accumulated prior to March 1, 1913.—

Ruling. . . . . 4. Where a corporation, having a surplus accumulated in part prior to March 1, 1913, and being thereunto lawfully authorized, transfers to its capital account a portion of its surplus, issues new stock representing the amount so transferred to the capital account and then declares a dividend payable in part in cash and in part in shares of the new issue of stock, that portion of the dividend paid in cash will, to the amount of the surplus accumulated since March 1, 1913, be deemed to have been paid out of such surplus, and be subject to tax, but the portion of the dividend paid in stock will not be subject to tax as income. . . . . (C. B. 3, page 38; T. D. 3052.)

The Supreme Court has held that a stock dividend is not a distribution. Therefore, the cash dividend would be applied to the earnings accumulated after March 1, 1913. In other words, capitalizing surplus by means of a stock dividend will not serve to render cash dividends tax-free unless and until the surplus accumulated since March 1, 1913, has been distributed in cash.[8]

Stock dividend in preferred stock.—A dividend in preferred stock is held not to be taxable,[9] because the amount thereof is transferred from surplus to capital, and as each existing stockholder receives a pro rata share of the new preferred stock there is no change whatever in the evidences of interest in the corporation's net worth. Each stockholder has the same proportionate share after the dividend as before. If the charter or by-laws of a corporation permitted it to distribute new stock to certain of its stockholders to the exclusion of others it could hardly be deemed to be a stock dividend.

If there is an existing issue of preferred stock and additional shares of preferred are issued to common stockholders as a dividend, the position of the common stockholders will be changed if the earnings are insufficient to pay the preferred stock dividend or in case of dissolution.

[8] I-40-529; Sol. Op. 144.
[9] Art. 1548. See page 765.

RULING. A stock dividend paid in true preferred stock is exempt from tax the same as though the dividend were paid in common stock; however, if the stock issued and distributed as a dividend ranks with or prior to the interest of general creditors (with respect to the payment of either interest or principal), it can not be considered true preferred stock, and must be treated as income to the recipient. (C. B. 4, page 24; O. D. 801.)

Stock dividends received from subsidiary companies.—When a subsidiary corporation declares a stock dividend, the holding corporation owning the majority of the stock of such subsidiary, if it has not theretofore taken up the surplus of the subsidiary, may set up on its books as an asset, its interest (the percentage of its ownership of stock) in that part of the surplus capitalized on the books of the subsidiary corporation for the purpose of the stock dividend which has been earned by the subsidiary since the date of acquisition by the parent company. In other words, if the holding company owned 93 per cent of the subsidiary, it would be justified in entering on its books the stock dividend at a value equal to 93 per cent of the amount of surplus since date of acquisition, transferred to the capital account on the books of the subsidiary. The amount so transferred or capitalized is ordinarily, if not invariably, the par value of the stock issued as a dividend.

It has been urged that the dividend may be set up "at the same value as the cost per share of its original holdings in said subsidiary," but this is not correct. Assuming that $100 per share, i.e., the par value, is regarded as the cost to the holding corporation, the statement quoted would produce the same result as the above rule. This, however, would really be a mere coincidence. If the holding corporation has purchased control for more or less than par, and if this value is so recorded on its books, such procedure would not produce the desired results.

The holding corporation could of course declare a stock dividend on the amount that it credits to surplus on account of the value placed on the stock dividend received from the subsidiary.

Dividend paid in stock of another corporation is not a stock dividend.—When a new corporation has been organized to take over certain properties of an old corporation and the stock that the new corporation paid to the old for such properties is distributed as a dividend to the stockholders of the old corporation, the dividend is held not to be a stock dividend[10] and it is therefore subject to surtax.

RULING. . . . . 5. A dividend, paid in stock of another corporation held as a part of the assets of the corporation paying the dividend, is income to the stockholder at the time the same is made available for distribution to the full amount of the then market value of such stock (*Peabody v. Eisner,* 247 U. S. 347); and if such stock be subsequently sold by the stockholder, the difference between its market value at date of receipt and the price for which it is sold is additional income or loss to him, as the case may be. . . . . (C. B. 3, page 38; T. D. 3052.)

This ruling is sound. If the stock received does not have a fair market value, the equivalent of cash, no tax can be imposed until sale is made. The proceeds of sale, when realized, are free from the normal tax. Section 216 of the law would appear to free dividends from the normal tax in any event, but the intention of the section is to apply the credit for the normal tax only up to the earnings or profits upon which income tax has been imposed.[11]

Certain dividends paid in scrip are stock dividends.—

RULING. A corporation declared a dividend payable in stock of the company at par. In making the distribution of fractions of shares scrip certificates were issued. In order to facilitate the disposal for the stockholders of their scrip, where they did not desire to purchase additional scrip to entitle them to a full share of new stock, the corporation sold in the open market as an agent of the stockholders the scrip certificates received for fractional shares of dividend stock. The sale was entirely optional with the stockholders.

Held, that the scrip certificates received as a dividend do not represent a cash dividend but a stock dividend and are not subject to tax. (C. B. 4, page 24; O. D. 859.)[12]

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[10] *Rockefeller v. U. S.,* — U. S. —, 66 L. Ed. —, 42 Sup. Ct. 68. Also see cases cited on page 726.

[11] Section 216 (a). See pages 363-365.

[12] For further discussion of scrip dividends, see page 728 *et seq.*

Stock dividends on no-par value stock.—The declaration of dividends on no-par value stock presents no special tax problem. If paid in stock, property or cash, the recipient must account for what he receives as if the dividends arose from par value stock. The bookkeeping procedure of the paying corporation, however, is not the same in the case of stock dividends. It will be assumed that on the books of a corporation, which has outstanding shares of no par value, the original paid-in capital and/or capital surplus are segregated from earned surplus. When a dividend is declared, payable in additional no-par value stock, what entry, if any, should be made in the earned surplus account? It is found that accounting authorities differ regarding the proper entry. If the dividend declaration is in dollars per share, no problem is involved. Earned surplus is debited and capital is credited. But such dividends usually are declared in stock as such with no mention of the dollar value. For such declarations the following book entries or methods have been suggested:

I. Make no entry in dollars. Enter in the capital account which shows the number of shares outstanding the additional number of shares. When the balance sheet is stated, show the total number of shares outstanding. The interest of the shareholders in the capital accounts and in the earned surplus is precisely the same as if no additional shares had been issued. The United States Supreme Court in *Eisner v. Macomber* decided that a stock dividend is not a distribution. If there has been no distribution, why debit earned surplus?

This principle also applies where the certificate of incorporation calls for a fixed amount of capital rather than a per share value. A stock dividend could not impair the original capital.

Shortly stated, a stock dividend ostensibly out of earnings is not a dividend at all in the common meaning of the term. A corporation may have $1,000,000 of capital stock represented by 10,000 shares of $100 each and $1,000,000 earned surplus. It changes the par value of each share to $10 and issues

100,000 shares in place of 10,000 shares. No one would suggest any change in earned surplus account. Another corporation has outstanding 50,000 shares of no-par value stock, and original or stated capital of $1,000,000 and earned surplus of $1,000,000. It declares a stock dividend of 50,000 shares, after which the stockholders hold 100,000 shares instead of 50,000 shares. In neither case has the corporation distributed anything except pieces of paper. One is called a reduction in the par value of its shares. The other is called a stock dividend. There is, however, a difference in substance.

In the first case anyone would know that the only change has been an increase in the number of shares outstanding.

In the second case, it would be inferred, and properly so, that the purpose is to segregate or capitalize part of the earned surplus and thus retain it in the business. This object is not accomplished if no transfer is made to capital account, because the undiminished surplus may then be drawn upon for cash dividends.

II. Make entry for statutory or declared value per share. If a minimum value must be ascribed to each new share issued, it is necessary to segregate the capital and the earned surplus accounts because dividends can or should only be paid from earned surplus. As the capital account must be increased by an amount representing the stock dividend shares at the minimum value per share, it follows that this sum must be debited to earned surplus.

III. Make entry of an amount derived from the percentage of new shares to old shares. Assume that there are outstanding 10,000 no-par value shares, and there is stated capital and earned surplus each $110,000. A stock dividend of 1,000 shares is declared. It is suggested that there be transferred to capital $11,000, that bearing the same percentage to $110,000 as the number of shares (1,000) of the dividend bears to the number of shares (10,000) previously outstanding. After the entry the books show capital $121,000 and earned surplus $99,000. The principle underlying the entry is that

before the dividend there were outstanding 10,000 shares and each share represented $11 of stated capital. If there is a dividend equal to 10 per cent of outstanding shares, there should be capitalized 10 per cent, or $11,000, of the earned surplus. After the dividend the capital per share is the same. The earned surplus alone is reduced.

Good practice requires directors to state in a stock dividend declaration in no-par value shares the amount of earned surplus which is capitalized.

Computation of Profit or Loss on Sales of Stock Dividends or of Stock upon Which Such Dividends Were Declared

When stock received as a stock dividend is sold, the proceeds are treated as if part or all of the original holdings were disposed of. In such cases the taxpayer may secure the benefit of the 12½ per cent rate on capital gains if the original stock has been held for at least two years. (See article 1651 on page 627.) When stock issued as a dividend is redeemed by the issuing corporation, it would seem to partake of the realization of a true dividend and be taxed as a dividend.[13] At the time the stock dividend was declared it was not a distribution; when redeemed in cash it certainly becomes a distribution. The proceeds are free from normal tax but whether or not subject to the surtax rather than to the 12½ per cent tax on capital gains depends on the interpretation which the courts give to the law. Certainly only the original holders would be deemed to receive a dividend. When stock, acquired from the original holders, is subsequently redeemed, the recipient does not receive a dividend but the equivalent of the proceeds of a sale.

General rules for ascertaining cost.—

Regulation. Stock issued by a corporation as a dividend does not constitute taxable income to a stockholder in such corporation, but gain may be derived or loss sustained by the stockholder from the sale of such stock. The amount of taxable gain derived or deductible

[13] See Chapter XXVII.

loss sustained from the sale of such stock, or from the sale of the stock with respect to which it is issued, shall be determined as provided in article 1561, after the cost, or both the cost and fair market value as of March 1, 1913, if acquired prior thereto, of both the old and the new shares is determined in accordance with the following rules:

WHEN SHARES ARE OF SAME CHARACTER.—

(1) Where the stock issued as a dividend is all of substantially the same character or preference as the stock upon which the stock dividend is paid, the cost of each share (or when acquired prior to March 1, 1913, the fair market value as of such date) will be the quotient of the cost (or such fair market value) of the old shares of stock, divided by the total number of the old and new shares. . . . . (Art. 1548.)

To illustrate:

1920	100 shares common, purchased at 50 =	$5,000
1922	10 shares of common, received at a 10% stock dividend	.....
	110 shares	$5,000
	New cost of each share is deemed to be $5,000 ÷ 110	$45.45

Cash redemption of stock dividends declared out of earnings accumulated since March 1, 1913, should be entered as dividends.[14] The circumstances of each particular case are to be carefully considered to determine whether or not such redemption is to be deemed to be the equivalent of a cash dividend. The distinction may be very important, because if the redemption is to be accounted for as a cash dividend, the entire amount (if entirely out of earnings accumulated after March 1, 1913) will be subject to surtax, whereas if the realization is to be accounted for as a disposition of stock owned, only the profit, if any (computed as set forth in article 1548), is taxable.

As the corporations issuing them have charged the stock dividends to surplus account, and paid the normal income tax thereon as the earnings were realized and credited to surplus, the stockholder's holdings are free from normal tax.

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[14] Section 201 (d).

WHEN SHARES ARE OF DIFFERENT CHARACTER.—

REGULATION. . . . . (2) Where the stock issued as a dividend is in whole or in part of a character or preference materially different from the stock upon which the stock dividend is paid, the cost (and when acquired prior to March 1, 1913, the fair market value as of such date) of the old shares of stock shall be divided between such old stock and the new stock, in proportion, as nearly as may be, to the respective values of each class of stock, old and new, at the time the new shares of stock are issued, and the cost (or when acquired prior to March 1, 1913, the fair market value as of such date) of each share of stock will be the quotient of the cost (or such fair market value as of March 1, 1913) of the class to which such share belongs divided by the number of shares in that class. . . . . (Art. 1548.)

RULING. In explanation of rule 2 contained in article 1547 [Regulations 45][15] . . . ., the following example is given:

. . . . The X Company, which has outstanding a certain number of shares of common stock of a market value of $90 per share, declares a 10 per cent stock dividend payable in preferred stock having a market value of $120 per share. A, who owns 100 shares of common stock having a market value of $9,000, receives 10 shares of preferred stock which have a market value of $1,200, making the market value of his holdings on the date of the receipt of the dividend $10,200, of which 15/17 represents the value of the common stock and 2/17 the value of the preferred stock. If the common stock cost the shareholder $8,500 (or if it was acquired prior to March 1, 1913, and had on that date a value of $8,500) such cost or value shall be apportioned to the common and the preferred stock in the ratio of 15 to 2. In other words 15/17 of $8,500, or $7,500, represents for the purpose of determining gain or loss the "cost" or the fair market value, as the case may be, of the 100 shares of common stock in respect to which the preferred stock was issued. The basis for determining the gain or loss arising from the sale of any share of such common stock will, therefore, be $75.

Of the $8,500 representing the original cost of the 100 shares of common stock, or their market value as of March 1, 1913, if they were acquired prior to that date, 2/17, or $1,000, will represent the "cost" of the 10 shares of preferred stock received as a dividend, the basis for determining the gain or loss upon the sale of each share of such stock being $100. (C. B. 3, page 39; O. D. 732.)

In tabulated form, this appears as follows:

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[15] Art. 1548 of Reg. 62.

	Market value per share	Total market value	
100 common	$ 90[16]	$9,000	(a)
10 preferred	120	1,200	(b)
		$10,200	(c)

Ratio of (a) to (c) = 15/17 × $8,500 = $7,500 = new cost of 100 common
Ratio of (b) to (c) = 2/17 × $8,500 = $1,000 = new cost of 10 preferred

Purchases at different times and different prices.—

Regulation. . . . . (3) Where the stock with respect to which a stock dividend is issued was purchased at different times and at different prices and the identity of the lots can not be determined, any sale of the original stock will be charged to the earliest purchases of such stock. . . . . and any sale of dividend stock issued with respect to such stock will be presumed to have been made from the stock issued with respect to the earliest purchased stock, to the amount of the dividend chargeable to such stock.

(4) Where the stock with respect to which a stock dividend is declared was purchased at different times and at different prices, and the dividend stock issued with respect to such stock can not be identified as having been issued with respect to any particular lot of such stock, then any sale of such dividend stock will be presumed to have been made from the stock issued with respect to the earliest purchased stock, to the amount of the stock dividend chargeable to such stock. (Art. 1548.)

The last paragraph (4), of the foregoing regulation was not in the old regulations.[17] When the dividend stock cannot be identified as issued to any particular purchase, it must now be allocated to the earliest purchased stock. Formerly, a taxpayer was permitted to "allocate, according to his wishes."[18]

The author has suggested in previous editions of this work that purchases should be averaged, as such method accords with good accounting practice. It is easily computed and readily understood and in the long run produces the same amount of tax. Although in almost universal use among financial and business men, the method has not found favor with the Treasury.

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[16] The market value of $90 is considered to be *after* the dividend is distributed.

[17] T. D. 3238 (October 22, 1921) added paragraph 4 to Art. 1547, Reg. 45.

[18] C. B. 3, page 40; O. D. 735.

The principle of allocation to the earliest purchases has been stated in a recent case[19] as follows:

Decision. . . . . The law may, and in fact does, recognize an identity in every share, which can indeed be traced upon the books of the company, at least until certificates are consolidated and later subdivided. The purchase of a number of shares can be earmarked by the certificate, and it is an enormous convenience to keep the purchase separate. Yet it is possible and consistent when new shares are declared to attribute them ratably in subdivision of those already issued. They are not so entered on the books, it is true, but the books are not kept in accordance with the underlying doctrine of *Eisner v. Macomber*, 252 U. S. 189, 40 S. Ct. 189, 64 L. Ed. 521, in any event. At least the earlier certificates need not lose their separate identity because new shares are filiated to them in proper proportion.

An illustration will make clear what I mean. Suppose a man has certificate A, for 100 shares, bought at $100, certificate B, for 100, bought at $150, and certificate C, for 100, bought at $200. Suppose, further, that a stock dividend of 50 per cent is declared, and he gets one certificate D, for 150 shares, without paying anything. If he sells certificate A, he would be deemed to sell not the whole of his first purchase, but only two-thirds of it, and he could credit himself with only $6,666. If he sold certificate B, he would credit himself with $10,000, and if certificate C with $13,333. If he sold certificate D, he could credit himself with $15,000, made up of $3,333 from his first purchase, $5,000 from his second, and $6,666 from his third. If, on the other hand, he sold only a part of certificate D, some arbitrary rule of apportionment must be adopted, allocating the shares sold among his purchasers. The most natural analogy is with payment upon an open account, where the law has always allocated the earlier payments to the earlier debts, in the absence of a contrary intention. Accordingly, if all the new shares were not sold at once, I think the first sales should be attributed to the first purchases still remaining unsold when the stock dividend was declared. I do not see that this method will result in confusion in its application, and it carries into effect the underlying theory of *Eisner v. Macomber*, supra.

The illustrations given on pages 768-770 show the procedure to be followed.

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[19] *Towne v. McElligott*, U. S. District Court, Southern District of New York, 274 Fed. 960 (August 5, 1921).

STATEMENT OF ACQUISITION OF STOCK AND COST

		No. of Shares	Cost
1909	Purchased	1,000	$ 84,800.00
1910	Stock dividend 33⅓%	333⅓	....
	Purchased	3⅓	495.75
	Total (average $63.81 per share)	1,336⅔	$ 85,295.75
1911	*Deduct:* Shares given to son, taken at $63.81 per share	16⅔	1,063.50
Mar. 1, 1913	Held at this date	1,320	$ 84,232.25
1914	Received as legacy, taken at market value at date of decedent's death	200	40,000.00
1917	(1) Stock dividend 50%	760	....
1918	Purchased	120	24,000.00
1919	(2) Stock dividend 25%	600	....
1920	(3) Stock dividend 40%	1,200	....
	Totals	4,200	$148,232.25

ALLOCATION OF STOCK DIVIDENDS TO EARLIEST PURCHASES OR ACQUISITIONS TO DETERMINE PROFIT ON SUBSEQUENT SALE

	No. of Shares	Cost
Stock held at March 1, 1913, at market value at that date	1,320	$264,000.00
(1) 50% stock dividend received in 1917 (50% of 1,320)	660	
(2) 25% stock dividend received in 1919 (25% of 1,980)	495	
(3) 40% stock dividend received in 1920 (40% of 2,475)	990	
	3,465 at $76.19 =	$264,000.00
Stock received as a legacy in 1914	200	$ 50,000.00
(1) 50% stock dividend received in 1917 (50% of 200)	100	
(2) 25% stock dividend received in 1919 (25% of 300)	75	
(3) 40% stock dividend received in 1920 (40% of 375)	150	
	525 at $95.24 =	$ 50,000.00
Stock purchased in 1918	120	$ 24,000.00
(2) 25% stock dividend received in 1919 (25% of 120)	30	
(3) 40% stock dividend received in 1920 (40% of 150)	60	
	210 at $114.29 =	$ 24,000.00
Total shares owned at June 30, 1921—as above	4,200 at $80.48 =	$338,000.00
1921 Stock sold at	1,000 at $70.00 =	70,000.00

Cost per share of shares owned at March 1, 1913, after allocating stock dividends = $84,232.25 ÷ 3,465 shares	$ 24.31
Cost of 1,000 shares sold in 1921	$24.310.00
Value as at March 1, 1913[20] of 1,000 shares sold in 1921	$76,190.00
Proceeds of 1,000 shares sold in 1921	$70,000.00

Since the sales price is less than value at March 1, 1913, but more than cost, the taxpayer reports neither gain nor loss.

The computation below illustrates the allocation of the cost between stock originally purchased and dividend stock of a different class when several different lots were purchased at different prices.

When more than one stock dividend is received, and various purchases have been made, the effect of the receipt of each stock dividend is to reduce the proportion of the cost to be assigned to each share of the increased number of shares. Each lot of purchased stock will usually carry a different original cost, and sales are made gradually eliminating the earliest purchases. There is thus a continually changing basis on which to compute profit from sale.

			Cost	Market Value
Purchased	10	shares common @ $100	$1,000	$ 900(a)
"	40	" " @ 80	3,200	3,600(b)
"	30	" " @ 40	1,200	2,700(c)
Total	80		$5,400	$7,200

10% Stock Dividend:

	1	share preferred	$ 80(d)
	4	" "	320(e)
	3	" "	240(f)
Total	8		$640

Ratio of (a) to (a) + (d) = 900/980=91.8
Ratio of (b) to (b) + (e) = 360/392=91.8
Ratio of (c) to (c) + (f) = 270/294=91.8

[20] See ruling (C. B. 1, page 30; A. R. R. 6).

Per cent	Total
91.8 × $1,000 = cost apportioned to first purchase, 10 shares of common = $91.80 per share	$ 918.00
91.8 × $3,200 = cost apportioned to second purchase, 40 shares of common = $73.44 per share	2,937.60
91.8 × $1,200 = cost apportioned to third purchase, 30 shares of common = $36.72 per share	1,101.60
Total new cost	$4,957.20

Cost apportioned to Preferred Stock Dividend:

8.2 × $1,000 = cost apportioned to stock dividend on first purchase, 10 shares of common stock	$ 82.00
8.2 × $3,200 = cost apportioned to stock dividend on second purchase, 40 shares of common stock	262.40
8.2 × $1,200 = cost apportioned to stock dividend on third purchase, 30 shares of common stock	98.40
Total cost apportioned to preferred stock dividend	$442.80

The above reveals that when sales are made from any one of the three lots shown a different cost is used for each lot.

In contrast with this method is the use of an average, to which the Treasury objects, viz.,

91.8 per cent of $5,400 (total cost as above) = $4,957.20 total new cost.
Total cost apportioned to old shares divided by number of old shares = $4,957.20 ÷ 80 = $61.97 average cost of old share.

Fractional shares must be used in ascertaining new cost.— When fractional shares of stock are received as a dividend, they serve to reduce the average cost. Sometimes adjustments are made in cash on account of such fractional shares, the cash payment representing the market price of the stock, which may be more than par. In such cases the amount of the payment should be returned as the proceeds of sale of a fractional share of stock.

Ruling. The resolution of the board of directors of a corporation, declaring a stock dividend, provided that no fractional shares of stock should be issued, but that all fractions of shares should be united into whole shares and sold by the treasurer and the proceeds thereof paid to the stockholders entitled thereto, such resolution having been approved by the stockholders. Held, that the stockholders by approving the action of the board of directors approved and, in fact, authorized the action of the treasurer, in uniting and selling the fractional shares and paying over the proceeds therefrom

to those stockholders entitled to the fractional shares, and that those stockholders entitled to receive fractional shares, but who actually received cash representing their portion of the proceeds of the sale of the fractional shares should compute the gain or loss thereon under the provisions of Treasury Decision 3059.[21] (C. B. 4, page 28; O. D. 781.)

Stock dividends declared out of surplus created by a reappraisal of or appreciation in assets.—There may be some justification for reappraising physical assets, but there can be no good excuse for issuing stock for goodwill unless it has been made the subject of sale.

It is to be hoped that only few such instances occur. Any corporation which writes up the value of goodwill, credits the amount to surplus account, and out of such alleged surplus declares a dividend, may expect to be charged with practicing a fraud on its stockholders and on anyone who afterwards acquires the stock. Goodwill when it appears on the balance sheet of a corporation or partnership is supposed to be carried at cost price or less, and any action which tends to obscure this inference may result in deception, even if there is no intention to deceive.

Refund of Taxes Paid on Stock Dividends

The procedure to be followed in claiming credit for taxes erroneously paid on stock dividends is given below:

RULING. A claim for credit on Form 47A[22] for payment of tax on stock dividends is to be accepted as a suspension of immediate collection of tax due only—

(1) Against income or income and excess-profits taxes due and unpaid.

(2) If amount claimed as a credit does not exceed the amount of tax collected on the stock dividend less any additional tax due and unpaid upon the sale of stock received as a dividend or stock upon which the dividend was declared. (The basis of determining the gain or loss upon sale of stock is stated in Regulations 45, article 1547, paragraphs 1 and 2. That article provides that the

[21] C. B. 3, page 38.
[22] Form now numbered 843.

cost of each share of stock is the quotient of the cost of the old stock divided by the number of old and new shares added together.)

(3) When accompanied by an affidavit of the taxpayer (supported by statements from the corporation which distributed the dividends as to the amount distributed to the taxpayer and years in which the profits distributed were earned) covering the following information:

(*a*) Whether the dividend consists of stock of the corporation distributing the dividend to the taxpayer, or of stock of another corporation acquired by the distributor.

(*b*) The name of each corporation declaring, the declaration of, and the date of receipt by the taxpayer of, the stock dividends, the tax on which was paid and is covered by the claim.

(*c*) The year in which the stock dividend was included in the taxpayer's return of income.

(*d*) The number of shares the taxpayer received and the value placed upon the dividend in the return. (If no sale of stock was made, the taxpayer need not furnish the following information.)

(*e*) If any sale has been made of stock of the corporation declaring the dividends, whether the stock be that acquired by a dividend, or upon which the dividend was declared, state—

(1) The number of shares sold.

(2) The selling price.

(3) The date or dates of sale.

(4) The portion, if any, of the selling price included as taxable profit in the return of net income for the year the sale was made and the item in the return under which the amount was reported.

(*f*) State how many shares of stock the taxpayer owned at the time he received the first stock dividend; how much that stock cost the taxpayer and the date the stock was acquired. (If acquired prior to March 1, 1913, state its value on that date and manner of determining the value.)

(*g*) State separately the dates from March 1, 1913, upon which you received stock dividends, the number of shares received on each date, and the names of the corporations distributing the dividends.

The receipt or canceled check covering the payment of tax involved in the claim should be attached to the claim. (C. B. 2, page 246; M. 2436.)

Stock dividends on shares carried on margin with broker.—

Ruling. A taxpayer in 1918 carried on margin with a stock brokerage firm shares of stock in a certain corporation. As the stock was not owned outright by the taxpayer it was not registered in his name but in the name of the broker, together with other

shares carried under similar conditions. Subsequently the corporation paid a stock dividend to its recorded stockholders, of which the brokerage firm was one, and it in turn distributed the same proportionately to the marginal owners.

For the purpose of making claim for credit or refund of the taxes paid on these stock dividends, the taxpayer should accompany his claim with a statement from the paying corporation showing the number of shares of stock standing in the name of the brokerage firm, and the amount of stock dividends paid to such firm during the year 1918; also a statement, signed by the brokerage firm, indicating the number of shares of the corporation's stock which the firm carried for his account, and the amount of stock dividends turned over to him by the brokerage firm. (C. B. 3, page 308; O. D. 625.)

Can recipient of stock dividend on which tax was paid refuse to accept refund of tax?—It is a nice question whether it might not be possible for a taxpayer who had sold his stock prior to the Supreme Court decision in *Eisner v. Macomber,* to maintain this position: that having followed the law and the regulations, and having paid the tax assessed against him, he was justified in assuming that the matter was entirely closed. In other words, the government would be estopped from collecting a greater tax in such cases.

If he is compelled to accept a refund of the tax paid on account of the dividend and amend his return on account of the sale, he may be assessed for a very large additional tax (e.g., in the case of a stock dividend declared before 1917, but sold in that year or later, income would be switched from low tax years to high tax years) for which he would not have been liable except for the action of Congress.[23]

Does Stock Dividend Belong to Life Tenant or to Remainderman?

On the question whether a stock dividend goes to the life tenant as income or to the remainderman as capital, there are

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[23] For further comment and illustration, see *Income Tax Procedure,* 1920, pages 498-99.

at least three rules.[24] The United States Supreme Court[25] and a minority of state courts give it to the remainderman. Among the states is Massachusetts,[26] although it holds the dividend taxable as income. England gives the stock dividend to the life tenant if it is an ordinary dividend and to the remainderman if it is an extraordinary one.[27] New York,[28] Pennsylvania[29] and several other states[30] split it. What comes from corporate profits acquired subsequent to the creation of the trust goes to the life tenant. What comes from earlier accumulations is kept for the remainderman.

Taxability of stock dividends paid to life tenants.—When stock dividends are paid to life tenants, the remaindermen are in hard luck. The new cost to the estate of the old shares is computed as follows:

. . . . On the receipt of the dividend by the trustee, there was no value added to the corpus of the trust, but as the new shares evidenced an interest in the assets of the corporation (which assets were neither increased nor diminished by virtue of the stock dividend), the value of the old shares necessarily was reduced in proportion to the number of all such new shares issued and not merely in proportion to the number of new shares retained by the trustee. As the original shares were reduced in value in the manner indicated as soon as the new shares were issued, the subsequent distribution of part of the stock dividend to the beneficiary, for whatever reason, could have no effect one way or another on the value of the shares retained by the trust. After the stock dividend, all shares, from the standpoint of their asset value, remained the same in value regardless to the subsequent distribution to the beneficiary. The conclusion is, therefore, that, from the standpoint of the trustee, capital and not income of the estate was distributed to the beneficiary within the meaning of *Eisner v. Macomber* (252 U. S. 189), but that

[24] "The Judicial Debate on the Taxability of Stock Dividends as Income," by Thomas Reed Powell, *Bulletin of the National Tax Association,* Vol. V, page 247.

[25] *Gibbons v. Mahon,* 136 U. S. 549, 34 L. Ed. 525, 10 Sup. Ct. 1057.

[26] *Minot v. Paine,* 99 Mass. 101, 96 Am. Dec. 705.

[27] See note on pages 801-802 to *Brander v. Brander,* 4 Ves. Jr. 800 (Am. Ed.); 31 Eng. Rep. 414.

[28] *Matter of Osborne,* 209 N. Y. 450, 50 L. R. A. (N. S.) 510, Am. Ann. Cas. 1915, A. 298.

[29] *Earp's Appeal,* 28 Pa. St. 368.

[30] See cases cited in *Tax Commissioner v. Putnam,* 227 Mass. 522, 532, 116 N. E. 904, L. R. A. 1917 F. 806.

the distribution is income to such beneficiary and taxable to her upon the theory underlying Law Opinion 1013 (C. B. 2, p. 181). Consequently, in making the computation outlined in article 1548 of Regulations 62, for the purpose of determining the cost of the shares retained by the trustee in order to ascertain loss or gain on the sale by the trustee of any of the shares retained by the trust, there must be added to the original shares all of the shares issued as a stock dividend on account of such original shares. That part of the stock dividend subsequently distributed to the beneficiary can not, for the reason stated, be ignored in making the computation. . . . .[31]

As illustrating the foregoing ruling, assume the following:

CASE I

Estate owns	400 sh.	cost	$100...........	$40,000
Stock dividend received by estate....	100 sh.		....	
	500 sh.	at	80...........	$40,000

Stock dividend distributed to life tenant, 100 shares, having a market value at date of distribution, is income to the life tenant to the amount of the fair market value at that date. Assume in the case illustrated that the market value of the stock after the stock dividend declaration was 90. Then the life tenant would report as income $9,000. If the estate should sell any part of the original 400 shares, the gain thereon would be computed by using a cost of $80 per share instead of $100, the original cost of each share.

Apparently the contention was made in the case covered by I. T. 1506, that where part of the stock dividend was retained by the trustee, only the number of shares so retained should be used to "dilute" the cost of the original shares. For example, assume in the above case that only 50 shares of the 100 share stock dividend was distributed to the beneficiary. The computation would be made as follows:

CASE II

Original shares	400 sh.	cost[32]	$100.........	$40,000
Number of shares of stock dividend retained by trustee	50 sh.		....	
	450 sh.	at	88.88.........	$40,000

[31] I-47-604; I. T. 1506.
[32] After March 1, 1913.

The Treasury holds, however, that the method shown in Case I above must be followed. The ruling is so grossly inequitable that it cannot be expected to stand, unless the state and the federal statutes are solely responsible. In another ruling[33] it is held that if the stock dividend is out of surplus accrued prior to March 1, 1913, it is nevertheless taxable to the life tenant at market value, and the remainderman is deprived of any chance of receiving a tax-free dividend from the old surplus.

Retroactive Tax on Stock Dividends

When the 1921 law was being drafted there was considerable agitation in favor of the establishment of an excise tax on the issue of stock based on capitalization of surplus. Since no action was taken in 1921, it is not likely that any further attempt will be made to impose a retroactive tax on stock dividends, to recoup the revenue lost by the government by reason of the Supreme Court decision. There may, however, be an excise tax on future dividends or on those declared in 1922.

[33] I-47-605; I. T. 1507.

CHAPTER XXIX

INCOME FROM PARTNERSHIPS

The Revenue Act in effect ignores the partnership's existence[1] as an independent entity[2] and taxes the partners on the income from the business in substantially the same manner as though the income of each were received from an individual business enterprise.

This chapter deals with the peculiarities involved in the computation of the income from partnerships. Partnerships are defined on pages 33-39. Returns of partnerships are discussed on pages 104-106.

The general provision of the law governing the taxation of partnerships, which includes all partnerships, except limited partnerships of the "corporation" type,[3] reads as follows:

LAW. Section 218. **(a) That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed. . . .**

REGULATIONS. Partnerships as such are not subject to taxation under the statute, but are required to make returns of income.

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[1] [Former Procedure] The 1917 law applied an excess profits tax to partnerships.

[2] [Former Procedure] To avoid the high surtaxes the 1921 law extended to partnerships, as well as to individuals, the right retroactively to incorporate their business for the year 1921. It was provided that capital must be an income-producing factor, in which case incorporation could take place at any time up to March 23, 1922. For details see *Income Tax Procedure*, 1922, pages 796-797. In no case was it beneficial for a partnership to adopt this procedure except when the earnings were large and were not withdrawn from the business. See also law, section 229.

[3] See page 39.

. . . . Individuals carrying on business in partnership are, however, taxable upon their distributive shares of the net income of such partnership, whether distributed or not, and are required to include such distributive shares in their returns. The net income of the partnership shall be computed in the same manner and on the same basis as the net income of an individual, except that the deduction of contributions or gifts is not permitted, as these are allowable deductions to the respective partners in their individual returns. . . . (Art. 331.)

The distributive share of the net income of the partnership which a partner is required to include in his return is his proportionate share of the net income of the partnership, either (*a*) for the taxable year upon the basis of which the partner's net income is computed, or (*b*), if the partner's net income is computed upon the basis of a taxable year different from that upon the basis of which the net income of the partnership is computed, for the taxable year of the partnership ending within the taxable year upon the basis of which the partner's net income is computed. Amounts earned and distributed to a partner by a partnership after the end of its taxable year and before the end of his corresponding taxable year should be accounted for both by the partnership and by the partners in their returns for their next succeeding taxable years. Where the result of partnership operation is a net loss, the loss will be divisible by the partners in the same proportion as net income would have been divisible, unless the partnership agreement provides for the division of a loss in a manner different from the division of a gain, and may be used by the individual partners in their returns of income. (Art. 332.)

Net Income of Partners—How Determined

The return of the partnership (form 1065) serves two useful purposes: (1) It is such a compilation as would have to be prepared by the partnership in any event, in order to assemble and segregate the taxable, partly taxable, and non-taxable income, and the allowable and non-allowable deductions; (2) after the compilation is made the distributive share of each partner is so stated as to set forth clearly the manner in which it should be taken up in the partner's individual return.

Net income of a partnership defined.—The tax is to be levied on the distributive shares "of the net income of the

partnership," and this phrase is defined in the law as follows:

Law. Section 218. . . . . (c) The net income of the partnership shall be computed in the same manner and on the same basis as provided in section 212 except that the deduction provided in paragraph (11) of subdivision (a) of section 214 shall not be allowed. . . . .

Section 212 describes the method of determining the net income of individuals and section 214 (a-11) permits the deduction of certain gifts[4] up to 15 per cent of the taxpayer's net income. The effect of the section of the law quoted above, therefore, is to put a partnership on exactly the same basis as an individual, so far as determining net income is concerned, with the single exception that gifts of the type described may not be deducted. The distributive shares of the partnership profits, however, form a part of the individual partner's "net income," from which such gifts may be deducted up to the limit of 15 per cent. Consequently no disadvantage accrues to the partnership because of the provision forbidding the deduction.[5]

Whether or not the contributions made directly by the partnership exceed the 15 per cent limit, the individual partners must return as their share of the net income of the partnership the full distributive share without any deductions for contributions. The credit to which each partner is entitled depends upon the entire taxable income of the partner and is

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[4] See Chapter XXXIX.

[5] **[Former Procedure]** In 1917, the only year in which the excess profits tax applied to partnerships, it was advantageous for a partnership to be permitted to deduct contributions in the partnership return.

Ruling. Recommended, upon reconsideration of the appeal of the M Company, a partnership, that the action of the Income Tax Unit in disallowing a deduction on account of contributions made to the American Red Cross in 1917 by the partnership be reversed, and that the firm be allowed, under the provisions of section 206 of the Revenue Act of 1917, to deduct charitable contributions or gifts, as described and limited in section 5 (a) of the Revenue Act of 1916, as amended, even though such contributions were not so closely connected with the trade or business as to secure to it some definite benefit or consideration.

Committee Recommendation 245 (C. B. 3, page 323), is hereby revoked. . . . . [C. B. 5, page 274; A. R. R. 651 (Sol. Op. 116).]

The foregoing ruling is in accord with the author's position as stated in *Income Tax Procedure,* 1919, page 830.

not affected by the relation of the contributions of the firm to the total income of the firm.

Donations should be charged to a special ledger account, which should be closed by transfers to the partners' accounts. Each partner will then be able to determine whether or not the 15 per cent allowance has been exceeded in his case. This special account should include only those donations subject to the 15 per cent limitation. All other donations, properly classified as expenses, should be charged to appropriate expense accounts.

Credits for certain dividends and interest, normal tax only.—The "distributive share" upon which the partner is taxable includes certain items which, when received directly as a part of an individual's income, are subject only to the surtax rates. Such items are dividends from certain classes of corporations and interest on certain government securities whose terms of issue provide for exemption from the normal tax. The law definitely provides that the identity of these items shall be preserved so that each partner may claim as a credit his proportionate share of the income represented by them.

LAW. Section 218. . . . . **(b) The partner shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the partnership. . . . .**

Subdivisions (a) and (b) of section 216 describe the dividends and interest referred to.[6]

REGULATION. In addition to the credits ordinarily allowed to an individual, a partner is entitled to the following credits: (*a*) A credit against net income for the purpose of the normal tax only of proportionate shares of such dividends specified in section 216 (a) and article 301, and of such interest not entirely exempt from tax upon obligations of the United States and bonds of the War Finance Corporation as are received by the partnership; and (*b*) a credit against

[6] See pages 363 and 365.

income tax of the partner's proportionate share of any income, war profits, and excess profits taxes of the partnership paid or accrued during the taxable year to a foreign country or to any possession of the United States subject to the limitations of section 222 of the statute. . . . . (Art. 333.)

The procedure regarding exemption for dividends, interest and taxes[7] is fully outlined in the respective chapters dealing with those subjects and in the chapters on returns.

Interest on tax-exempt bonds to be entirely omitted from the calculation of net income.—The basis prescribed for the calculation of net income in section 218 (c), quoted on page 779, plainly excludes all interest upon tax-exempt securities.[8]

Identity of income of partnership—how far traceable.—In the gross earnings or expenses of a partnership there may be items other than the specified dividends or interest which would be favorably treated in the returns of individuals if segregated from the partnership profits. If there are such items partners may confidently report them separately.[9]

Information needed to take advantage of credits and reductions.—In view of the credits and deductions set forth in the preceding paragraphs, the partner should, before preparing his personal return, secure from the partnership specific information regarding the following points in addition to the mere statement of net profit or net loss.[10]

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[7] The 1918 law quite properly specified that credit for 1917 excess profits taxes upon partnership income for a fiscal year ending in 1918 should be restricted to that portion of the partner's distributive shares falling in 1917. Section 218 (c).

[8] [Former Procedure] For full discussion of the foregoing, see *Income Tax Procedure,* 1919, pages 372-373.

[9] [Former Procedure] Regulations 33 were subject to criticism. It happens that under the 1916 law, the 1918 law and the new 1921 law the kinds of partnership income which it is an advantage to "identify" are "specially provided for." Therefore taxpayers are not concerned at present about the restriction. For text of old regulations, court decisions and comments, see *Income Tax Procedure,* 1920, page 505.

[10] Which it is assumed would be drawn up in accordance with the law and the regulations. See Art. 412.

1. Dividends received:
   (a) When from domestic corporation not entitled to benefits of section 262.[11]
   (b) When from foreign corporation which derives 50 per cent of its gross income from sources within the United States.[12]
2. Interest received upon "obligations of the United States and bonds issued by the War Finance Corporation which is included in gross income under section 213" of the law.[13]
3. Gifts[14] (other than those deductible by the partnership because of their being really business expenses).
4. Foreign income or excess profits taxes.[15]
5. Capital gains and losses (see Chapter XXII).

Deduction for partnership losses.—Partnership losses are, of course, deductible in the returns of the individual partners. The following regulation explains the basis of their division among the partners:

REGULATION. Losses sustained during the taxable year . . . . are fully deductible . . . . if (*a*) incurred in a taxpayer's trade or business, ... (Art. 141.)

Even though the distributive share on the firm's books is a net profit, if the aggregate of dividends and interest described on page 780 is greater than the net profit the difference is an allowable deduction as a loss to the partner.

If the books of a partnership show a net profit of $40,000 with two equal partners, each is subject to *surtax* on his distributive share, irrespective of the character of the income.

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[11] See Chapter XLI.

[12] See *Ibid.*

[13] **[Former Procedure]** The 1918 law required that interest entirely exempt, including that received on Farm Loan bonds, be reported but not included in net income. The 1921 law did not re-enact this requirement. See page 781.

[14] See Chapter XXXIX.

[Former Procedure] When fiscal years ended in 1918, other than at December 31, 1918, it was necessary to know the amount of partnership income subject to the 1917 income and excess profits tax rates.

[15] For method of obtaining credit, see Chapter XXXIII.

If the firm has received $50,000 in dividends each partner should return $25,000 from that source and claim credit for a loss of $5,000. The amounts entered as dividends will be free of normal tax, and the difference between $25,000 and $5,000 ($20,000 each) will automatically be subject to the surtax, which commences at $6,000.

Net loss provision applies to partnerships.—

LAW. Section 204. . . . . **(c) The benefit of this section** [providing for the application of net losses to the income of succeeding years (see Chapter XXXIV)] **shall be allowed to the members of a partnership. . . . .**

REGULATION. . . . . Where the result of partnership operation is a net loss, the loss will be divisible by the partners in the same proportion as net income would have been divisible, unless the partnership agreement provides for the division of a loss in a manner different from the division of a gain, and may be used by the individual partners in their returns of income. (Art. 332.)

This subject is discussed in detail in Chapter XXXIV.

Profits from sale or exchange of capital assets.—Since the 1921 law taxes capital gains on a different basis from other profits,[16] it is important for partnerships to keep a separate record of all sales or exchanges of capital assets.

LAW. Section 206. . . . . **(c) In the case of a partnership . . . . the proper part of each share of the net income which consists, respectively, of ordinary net income and capital net gain, shall be determined under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary, and shall be separately shown in the return of the partnership . . . . , and shall be taxed to the member . . . . as provided in sections 218 . . . . , but at the rates and in the manner provided in subdivision (b) of this section.**[17]

REGULATION. Under subdivision (c) of section 206 the members of a partnership shall be taxed as provided in section 218, but with respect to any capital net gain, may elect to be taxed as provided in section 206. Similarly estates or trusts or the beneficiaries thereof shall be taxed as provided in section 219, but with respect to any capital net gain may elect to be taxed as provided in section 206. In

[16] This subject is discussed in detail in Chapter XXII.
[17] See page 625.

all cases, however, of election to be taxed under section 206 the minimum tax on the total net income (ordinary net income plus capital net gain) is 12½ per cent. Where the net income of a partnership, estate, or trust consists in whole or in part of capital net gain, there shall be attached to the return, upon the request of any member or beneficiary (or without such request) at the election of a fiduciary of an estate, a statement showing (1) all items of capital gain, capital loss, and capital deductions, as provided in article 1652, and (2) the names of members or beneficiaries and the amounts of their respective shares in such capital net gain. (Art. 1653.)

The members of partnerships may elect the basis upon which they shall be taxed. This may result in the same capital gain being taxed on two different bases as to the respective shares of partners therein.

Return of estimated profits on joint accounts.—

Ruling. In case two distinct partnerships enter into a single venture under agreement to terminate in two years no part of profit to be distributable or drawings allowed during that period and any profit to be held intact until the latter part of 1919, the amount of profit realized and determinable each taxable year should be reported proportionately in the respective returns of the partnerships regardless of the agreement. Individual members of each partnership are subject to tax upon their pro rata share of profit even though actual distribution is postponed until termination of the agreement. (C. B. 1, page 174; O. D. 187.)

The foregoing is sound only so far as there is an amount of "realized and determinable" profit before the end of the period. If it is a single venture there can hardly be a realized profit unless and until the venture as a whole is closed. The case is not analogous to the closing of books upon an inventory or accrual basis.

The accounting period.—The partner is taxable[18] on his distributive share of the net income "for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed." The 1918 law, it will be recalled, permitted an individual, for

[18] Section 218 (a).

the first time, to report on the basis of his fiscal year. The phrase just quoted makes it clear that a partnership having a fiscal or closing period different from that of the individual partner, need not attempt to make an additional closing of the books or ascertainment of profits or losses in order that the partner may return his share of the net profits or losses of the partnership for his full, personal fiscal year. Different partners may, indeed, have fiscal years ending at various dates and to insist upon a closing of the books in each instance would be out of the question.

What the government wants from an individual who is a partner in one or more firms is a full and accurate return of his share of the partnership profits for the twelve months[19] ending at some date during his personal fiscal year. The acceptance of this as sufficient obviates the necessity of guessing or roughly calculating the partner's income when the fiscal year of the partnership does not agree with that of the partner. It is convenient and accurate to report the amount shown by the partnership records, and as the income tax has come to stay, individuals should change their own fiscal periods to the regular closing date of their partnerships, unless there are valid reasons to the contrary.

It should be borne in mind that so-called salaries paid to partners are in effect a distribution of anticipated profits (Chapter XXXI). They may, however, have been deducted on the partnership books in determining the net annual profits distributable at the end of the fiscal year. *If so deducted* such salaries should be included as taxable income, for the year in which received, in each partner's individual return, in addition to his remaining share of the partnership profits for the fiscal year mentioned above.

When a partnership begins business at some date other than January 1 and it is intended to establish a fiscal year ending twelve months thereafter, the partnership makes no re-

[19] The return cannot be for a period greater than twelve months (C. B. 1, page 168; O. 816).

turn as of December 31. If the partners keep their personal books on the same fiscal year basis no returns are required for December 31. But if the partners do not establish fiscal years they must report as of December 31. In their returns for the first calendar year, neither profit nor loss from the partnership is returned. Partners' salaries paid between the close of the partnership's fiscal year and the partner's individual tax period, should not be reported by individuals until the partnership's full year has elapsed, as the partnership might have a net loss for the year, in which event the salary would in part or in whole not be income but a withdrawal of capital.

If, due to a change in fiscal years, a partnership chances to have two taxable periods which terminate within a partner's taxable year, the distributive shares for both of the periods must, under a Treasury ruling, be reported in the partner's return. (See C. B. I-1, page 208; A. R. R. 916.)

Procedure when personal and partnership accounts are on different bases.—A partner may have been accustomed to keep his personal accounts on a cash basis, while his firm's accounts are on an accrual basis. In such a case he may continue to keep his personal accounts as before if it is not practicable for him to change to an accrual basis, but in reporting his share of firm profits or losses he must include the entire amount of profit or loss accrued to or incurred by him on the firm's books for the fiscal or calendar year. It is immaterial how or when he receives his share, and whether or not the firm's books include many accrued items. In a similar way any expenses pertaining to his share of the partnership income, accrued on the partnership books, should be deducted by the partner when accrued.

Dissolution of or changes in partnership.—

Regulation. When a partner retires from a partnership, or it is dissolved, he realizes a gain or loss measured by the difference between the price received for his interest and the cost to him of his interest in the partnership, including in such cost the amount of his

share in any undistributed partnership net income earned since he became a partner on which the income tax has been paid. However, if such interest in the partnership was acquired prior to March 1, 1913, both the cost as hereinbefore provided and the value of such interest as of such date, plus the amount of the share in any undistributed partnership net income earned since February 28, 1913, on which the income tax has been paid, shall be ascertained and the taxable gain derived or the deductible loss sustained shall be computed as provided in article 1561. If the partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property received in liquidation. . . . . Whenever a new partner is admitted to a partnership, or any existing partnership is reorganized, the facts as to such change or reorganization should be fully set forth in the next return of income, in order that the Commissioner may determine whether any gain or loss has been realized by any partner. . . . . (Art. 1570.)

Upon the dissolution of or a change in a partnership and a distribution of assets in kind it is not probable that any taxable gain or profit would immediately arise. In a distribution upon the basis of book values there is no gain or loss, because it will be assumed that the partners in their individual returns will have accounted for all gains, profits or income which were shown on the books of the partnership. When the accounts of the partnership in dissolution are continued a partner may await the result of the transactions for the entire taxable year before taking up in his accounts any gain or loss.

The foregoing regulation refers to the cases where a partner *realizes* in cash or its equivalent some amount greater or less than is shown in his capital account in the firm's books.

Assume that the book value of a partner's one-half interest in the firm is $50,000. Goodwill is not carried as an asset. If the goodwill is valued at $40,000 and sold to the continuing partner or someone else for that amount the retiring partner will receive in cash $70,000. If the goodwill of the business on March 1, 1913, was worth $40,000 the retiring partner will not realize any taxable gain. If the fair market value of the goodwill on March 1, 1913, was $25,000 the retiring partner must report a realized profit of $7,500. If

the business was started after March 1, 1913, his taxable profit is $20,000.

Readjustment of partnership interests.—

Ruling. . . . . (1) If a retiring partner or the estate of a deceased partner takes his portion of the partnership property in kind there is no realization of income, such realization being postponed until the property so received is in turn sold.

(2) If, on the other hand, the retiring partner or the estate sells to the remaining partners his interest in the partnership for cash it is held that the difference between the cost, or value as of March 1, 1913, of such interest constitutes gain or loss for the purpose of computing the income of such partner or estate, and that the remaining partners, as a result of this transaction, have only added to their holdings in the partnership property. They have made a purchase and not a sale, and can have realized nothing in the way of profit or loss.[20] . . . . (C. B. 3, page 61; Sol. Op. 42.)

Assume that a retiring partner's capital account shows a credit balance of $25,000. He sells to a continuing partner for $20,000. If the latter subsequently converts the assets into the equivalent of cash at the book figures he will realize a profit of $5,000.

If, however, he purchases fixed assets or fails to convert other assets, the $5,000 credit to the retiring partner's account operates as a reserve and is not true surplus or gain.

Ruling. . . . . (3) The effect of the admission of a new partner depends upon the terms of his admission. If, under the terms of the partnership agreement he contributes property or cash to the capital of the partnership he acquires a right, upon dissolution, to a return of his contribution together with his proportionate share of the net profits of the partnership business, and in the meantime to a corresponding share in the net earnings of the partnership. There is no realization on the part of any partner. If, on the other hand, he purchases, for cash, an interest in the existing partnership, it is clear that what he has acquired is simply a right to share in the profits of the partnership during its continuance and in any sum remaining, upon the dissolution of the partnership, after the satisfaction of creditors and of the equities as between the contributing partners. Since this would represent a purchase, by the incoming partner, there could be no realization as to him, and, as to the mem-

[20] See C. B. 5, page 175; O. D. 1033.

bers of the former partnership, the amount paid by him will clearly be income to them in direct proportion to their respective interests in the former partnership and should be returned by them as such. (C. B. 3; page 61; Sol. Op. 42.)

Assets of old partnership taken over at current valuation.—In the detailed opinion (quoted in part above), the specific question was stated as follows:

An opinion is requested whether upon the dissolution of a partnership by the withdrawal or death of a partner and the formation of a new partnership which takes over the assets of the old partnership belonging to the remaining partners, at current valuation, the transaction is to be considered closed so that the increase in the value of the assets as written up on the books of the new partnership over the cost or value as of March 1, 1913, of such assets to the former partners constitutes taxable income to them. . . .

And the answer given by the Treasury confirms the position taken by the author that unrealized appreciation is not income.[21]

. . . . In other words, to hold that by valuing his contribution to the partnership at a greater amount than its cost to him, or value as of March 1, 1913, he could realize the difference as income would be to hold that the partner could make a profit by selling to himself. Such a conclusion is wholly at variance with the decisions of the courts and the rulings of this department. . . .

Distributions to partners other than in cash.—A partner should return for taxation the exact amount of net profit credited to his capital account in the books of the firm at the end of its fiscal year, after deducting tax-exempt interest, etc. Any payments to a partner charged against his capital account are, of course, not returnable because such payments merely represent distributions of capital or of income already reported and taxed.

The same principle applies to partnership distributions other than in cash. For instance, a firm may own property or securities which it wishes to divide among the partners.

[21] *Income Tax Procedure,* 1920, page 510.

The amount at which such items appear on the firm's books as assets determines the *book value* of the partners' interests therein, and when distribution is made the items should be entered by the partnership and the partners at book valuation. After distribution of the assets such book valuation is the basis of gain or loss, except that assets acquired before March 1, 1913, must be valued as of that date.

RULING. Where a distribution of partnership profits is made in securities carried in an investment account by the partnership, first each partner must be taxed on the basis of his distributable share of the partnership profits for the year 1917, which partnership profits will be ascertained without claiming any loss with regard to the unsold securities held in the investment account of the partnership; second, the individual partners receiving these securities as a distribution of partnership profits shall determine their future gain or loss when such securities are sold and on the basis of the cost of the securities to the partnership or their market value on March 1, 1913, if acquired before that date. (C. B. 1, page 46; Digest T. B. R. 34.)

Distributions by limited partnerships.—All divisions of profits by limited partnerships which are of the corporation type (see page 39 for definition) should be treated by the partners as dividends. The normal tax will have been paid, so that for 1922 the recipients will receive credit of 8 per cent on such distributions in calculating their normal tax.

As in the case with ordinary partnerships, undivided profits are not included in the returns of partners of the limited partnership.

PART III
DEDUCTIONS

CHAPTER XXX

DEDUCTIONS AND CREDITS—GENERAL

Method of treatment.—The statute specifies the particular deductions and credits which may be subtracted from gross income to determine taxable net income or from the tax as ascertained under certain sections to determine the net tax to be paid. These deductions and credits are listed separately in the law and differ somewhat with the character of the taxpayer—whether a corporation or an individual, or whether a resident or a non-resident. In this book all the peculiarities relating to non-resident aliens, including deductions, are relegated to a special chapter, XLI. The deductions and credits allowed to others than non-resident aliens, whether individuals or corporations, are consolidated and are treated topically in the series of chapters which follows.

Since the law is printed in full in the Appendix and since all the provisions relating to deductions are quoted verbatim under the various individual topics in the succeeding chapters, it is not necessary to give at this point the various lists of allowable deductions. For these the reader is referred to sections 214 (a) and 234 (a) of the statute.

Deductions limited to those specified in the statute.—While the tax is levied on "net income received," that term is not precisely the "net income" of the accountant's vocabulary. It is a resultant obtained by subtracting from gross income, as determined in the particular manner described in the preceding chapters, certain specified deductions which are discussed in the chapters which follow. In the language of the regulations:

Regulation. Net income is that portion of the gross income which remains after all proper deductions have been taken into account. . . . . (Art. 531.)

The law expressly excludes certain items usually regarded as legitimate deductions from income, and the Treasury has held that some other items of ordinary expenses are not allowable. Some of these restrictions apply both to individuals and to corporations. Others apply merely to one or the other. Neither individuals nor corporations, for example, may deduct special assessments of certain types or interest on money borrowed to purchase certain tax-exempt securities. On the other hand, an individual may deduct charitable contributions to a limited extent, while a corporation may not. Again, an individual may not deduct personal expenses, which makes it necessary to define personal expenses very carefully, while a corporation, of course, is presumed to have no "personal" expenses. But taxes imposed on an individual's residence and interest on money borrowed for personal use are not considered personal expenses. Moreover, under the 1918 and 1921 laws[1] an individual can deduct the net loss sustained by any "casualty" which happens to his automobile or other property (such as his residence), a loss which is nothing more than a personal or living expense. Furthermore, individuals may deduct the interest paid on loans which are used to defray personal expenses. Inconsistencies such as these give rise to most of the complications encountered in drawing up returns. Those charged with the preparation of returns should carefully study the provisions of the law bearing on deductions and be prepared to pass on the propriety of including or excluding the various items of expenditures which have been made.[2]

Accounting procedure.—The discussion of accounting procedure on page 397 *et seq* is applicable in large part to deductions as well as to items of income.

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[1] [Former Procedure] The 1916 and 1917 laws contained a like provision.

[2] The form of reconcilement statement which will be found in *Excess Profits Tax Procedure,* 1921, Chapter XV, affords a means of preventing the omission of any allowable deduction in the books, and as to classification it calls attention to any omission of allowable items not in the books.

CHAPTER XXXI

DEDUCTIONS FOR EXPENSES

General

The chief problems of procedure connected with deductions for expenses are occasioned by the presence of certain restrictions in the law itself. First of all, the statute forbids the deduction of personal living expenses.[1] This is quite necessary and proper, but it involves the difficult task of establishing a sharp line of demarcation between business and living expenses. Gifts,[2] in the next place, are not generally deductible; but in many cases it is not easy to determine whether a payment, nominally a gift, is not more truly an expense. The law does not permit the deduction of capital expenditures except in the form of depreciation allowances, and here once more it is necessary to set up a series of distinctions between this type of expenditures and business expenses proper. Again, care must be taken not to allow any distribution of profits under the guise of business expense. Other difficulties are caused by the prohibition of certain expenditures as contrary to public policy and by the necessity of taking a position on the question of insurance—as to how far expenses are deductible which seek to safeguard the income from risks of various sorts.

In this chapter the first general section is devoted to the establishment of the distinction between business and personal expenses and is consequently applicable to individuals only. The remainder of the chapter deals with various specific types of expenses and, unless otherwise specified, applies alike to

[1] This rule is considerably modified if section 214 (a-6) (allowing for losses arising out of casualties) is interpreted to cover ordinary accidents to personal property, the use of which has always been regarded as private or family expense.

[2] See Chapter XXXIX.

individuals, partnerships and corporations. In the case of many of these expenses the deductibility of a particular item becomes a complicated question involving several of the distinctions referred to in the preceding paragraph, as, for example, when a salary must be shown to be not a gift, a personal expense, a distribution of profit, a distribution of assets or a payment for property.[3]

Expenses which are deductible.—

LAW. Section 214. [Individuals] (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity;[4] . . . .

Section 234. [Corporations] (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity; . . . .

The principle underlying the deductions for expenses was well expressed in a ruling under the 1913 law, as follows:

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[3] [Former Procedure] Sections 214 (a-1) and 234 (a-1) of the 1921 law are identical with those in the 1918 law, except for the addition of the provision in the former relating to traveling expenses.

1916 LAW. Section 5. [Individuals] "(a) . . . . First. The necessary expenses actually paid in carrying on any business or trade, not including personal, living, or family expenses;"

Section 12. [Corporations] "(a) . . . . First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, ..."

[4] For comment on last two lines which were added by the 1916 law, see Chapter XXXII.

RULING. Only those expenses which are incurred in earning income which is subject to tax under the income tax law constitute allowable deductions in computing net income taxable under the law. (T. D. 2137, January 30, 1915.)

In general, there has been adherence to the foregoing principle. In some cases, however, expenses which have been incurred in earning taxable income have not been allowed.

Restrictions on expense deductions.—The restrictions on deductions for expenses are the following:[5]

LAW. Section 215. [Individuals] (a) That in computing net income no deduction shall in any case be allowed in respect of—

(1) Personal, living, or family expenses;

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made;[6] or

(4) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy. . . . .

Section 235. [Corporations] That in computing net income no deduction shall in any case be allowed in respect of any of the items specified in section 215.

Accrued expenses may be deducted.—When the accounts of a taxpayer are kept on the accrual basis all expenses incurred to the end of the taxable year, whether paid or not, are allowable deductions and should be entered in the books. It is, however, most reprehensible to enter accrued items of expenses unless all items of accrued income are also entered.

The term "expenses . . . . incurred" must be taken in its usual commercial sense. It would be improper for a concern

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[5] [Former Procedure] These provisions are identical with those of the 1918 law.

[6] See Chapter XXXVI.

to enter as an accrued expense at the end of the taxable year any items of which the business had not received the benefit.[7]

Business Expenses Distinguished from Personal Expenses

Definition of "business or trade."—The law specifies that an individual must not include "personal, living or family expenses" in his computation of deductible expenses. He may subtract under this head merely "the ordinary and necessary expenses paid or incurred . . . . in carrying on any trade or business."[8] "Business" and "trade" are used synonymously and have been defined as follows in an old regulation:

RULING. That which occupies and engages the time, attention and labor of anyone for the purpose of livelihood, profit or improvement; that which is his personal concern or interest; employment, regular occupation, but it is not necessary that it should be his sole occupation or employment. (T. D. 1989, June 2, 1914.)

It is apparent that this definition is broad enough to include professions of all types,[9] as well as various avocations and "side-lines."[10] Moreover, it is not necessary for a person to own a business in order to be in business or to have business expenses. Salaried officers and employees and persons receiving their remuneration on a commission basis often have business expenses which are necessary and are allowable as deductions. Recognition of this is found in the original edition of Regulations 45.[11]

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[7] An office telephone company sent out notices on December 27, 1918, to the effect that the signing of a contract for its service was sufficient to warrant the inclusion of the liability thereby incurred as an allowable expense in the 1918 accounts. The statement was incorrect. In the first place, if the equipment was a capital expenditure the cost could not have been deducted as an expense, and, in the second place, if it were an allowable expense item it should not have been allowed until the business received the benefit, which could not have occurred before the year in which the service was actually installed.

[8] Section 214 (a-1).

[9] The excess profits tax law of October 3, 1917, specifically included professions within the definition of "trade" and "business." (See section 200.)

[10] C. B. 4, page 119; O. D. 805.

[11] The preliminary edition of these regulations was issued soon after the enactment of the 1918 law.

REGULATION. . . . . Amounts paid from a salary received for all services rendered and expenses incurred are deductible as business expenses when the expenditures are occasioned by the services in respect of which the salary is paid. . . . . (Reg. 45, Art. 292.)

In the April 17, 1919, edition of the regulations the statement was omitted. The omission, however, cannot operate to deprive anyone of a deduction for business expenses which the law permits.

The circumstances of each case are considered by the Treasury in deciding whether expenditures are business or personal. Office rent paid by a taxpayer whose income is derived principally from investments, is deductible if it can be shown that such rent is ordinary and necessary.[12] Expenses incurred in making a trip to Washington in connection with the assessment of additional tax by the Treasury have been held to be deductible.[13] Rental of a safe deposit box is held to be deductible only when used in connection with trade or business.[14]

"Personal expenses" defined.—In a case involving the question whether or not transportation paid by a commuter is a deductible expense, the solicitor has very aptly defined personal expenses.

RULING. . . . . "Business expenses," as defined in article 101, Regulations 45, includes all items entering into what is ordinarily known as the cost of goods sold, together with selling and management expenses. In short, every necessary item of expense in conducting business, incurred primarily because of and solely in the furtherance of the business engaged in, is held to be an ordinary and necessary business expense.

To what extent can this definition of business expenses be applied? Does it include any and all expenses which in any way bear upon or have a relation to or a connection with the business engaged in by the individual? Obviously, amounts paid out for medical attention necessary for the upkeep of the body and the preservation of health are personal and have no connection with business. Likewise, sums paid to the grocer, to the tailor, amounts paid for insurance and

[12] C. B. 4, page 123; O. D. 877.
[13] C. B. 4, page 123; O. D. 849.
[14] Telegram to Guaranty Trust Co., signed by Commissioner Wm. M. Williams, dated March 8, 1921.

house rent. These expenses arise independently of business. The test, therefore, is whether an expense is incurred primarily because of business as the immediate cause inducing the expenditure.

. . . . Obviously, an individual is free to fix his residence wherever he chooses. He fixes it according to his personal convenience and inclinations, as a matter separate and apart from business. Any expense, therefore, incident to such residence as fixed by the individual is a matter personal to him. . . . .

It is therefore held that the cost of transportation paid by a salaried employee living at a distance from his employment, in order to go to and return from such employment, is not deductible as a business expense within the meaning of the Revenue Acts of October 3, 1913, September 8, 1916, as amended, and February 24, 1919. (C. B. 1, page 101; S. 1048.)

The foregoing ruling holds that traveling expenses, when incurred in connection with a taxpayer's duties, are allowable deductions. The ruling is sound. It is difficult, however, to distinguish between occasional and frequent business expenses.

If trips were made monthly, apparently the expense would be allowed; when trips are made daily the expense is not allowed. The principle does not seem to be logical. It would seem to be more logical to confine "personal, living and family expenses" to those which are expended whether or not a person is in business. If a person engages in business and is required to incur business expenses, the additional cost should be treated as a deduction from gross income. The solicitor (in Opinion 1048) falls into an error when he states that "obviously an individual is free to fix his residence wherever he chooses." In the case of the Congressman's secretary he was required to fix it in Washington.[15] Only when one enjoys a "lazy" income is one free to live where one likes. The author would like to see a court decision on the deductibility of the commuters' railroad fares.

Theory underlying the segregation of business expenses.— In the opinion of the author the exact line between personal and business expenses can be determined with theoretical ac-

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[15] C. B. 4, page 212; O. D. 865.

curacy by ascertaining whether or not the various items would have been expended had the taxpayer's income been derived from some source, other than business, which required no outlay for business expenses. For example, if a salesman or other employee receives a salary of $3,000 per annum, the query should be propounded: "What would his personal, living or family expenses be if his income of $3,000 were derived from investments?" Theoretically he should be permitted to deduct any additional expenses incurred over and above those which he would pay if he were free to live wherever he chose and in any manner he chose within the limitations of his $3,000 investment income. If in order to earn his salary he must purchase books, attend lectures and incur similar expenses, they should be proper deductions. If he must belong to a luncheon club and entertain at his own expense prospective or actual customers, the dues and other charges of the club should be considered as business expenses and therefore as allowable deductions. If, to be within reach of his place of business, he must live in a community where rents are high, this additional amount should be considered a business expense, as should also the cost of his commutation ticket on the railway.

There are, however, apparent difficulties in applying in practice the theoretical distinction worked out in the preceding paragraph. Moreover, the specific provision of the law forbidding the deduction of actual "personal, living or family expenses" complicates the situation, for, as a matter of fact, items which would ordinarily be classified as "family" and "personal" expenses (such, for example, as house rent) may be and often are at the same time true business expenses as ascertained by the test given above. The law forbids the deduction of the higher rent which A pays to be near his work and the regulations forbid the deduction of the commutation fare of B who prefers to spend time and railway fare rather than rent in order to secure accessibility to his business.[16]

[16] Art. 101 (a).

Theoretically both deductions should be permitted. To work out a complete solution it is necessary both to change the law, in order to recognize certain "living" expenses as business expenses, and to liberalize the present regulations.[17]

Importance of precise distinction.—The importance of distinguishing carefully between business and personal expenses and of securing a full deduction of the former is greatly emphasized by two elements in the situation. The first is that "unearned" income, which at present is taxed at the same rates as business income, and some types of which such as capital gains, are sometimes taxed at an even lower rate, often has no business expenses attached to it and consequently runs no danger of excessive taxation through failure to deduct such expenses. If business expenses are not completely deductible, business income stands at a still greater disadvantage, as compared with funded income, than is intended when the rates on both earned and unearned incomes are the same. In the opinion of the author the failure to tax unearned income at a higher rate than earned income in itself constitutes a sufficiently great discrimination without adding to it in this manner. The other element which emphasizes the desirability of carefully segregating business expenses is the fact that the average citizen of the United States is not given to a close analysis of his personal expenditures. He thus is apt to be taxed excessively, unless his attention is called to the importance of accurate accounts. Moreover, knowledge of one's personal expenditures undoubtedly leads to greater economy and increased savings. This, in turn, means larger amounts available for future income taxation, a fact which should not be overlooked by taxing authorities in framing regulations governing deductions for expenses.

Suggestion for segregating business expenses.—Where business expenses are intermingled with personal expenses, it

[17] For British practice see *Income Tax Procedure*, 1922, page 858.

is sometimes helpful to approach the problem in a negative fashion—that is, to ascertain first the amounts paid for personal, living and family expenses (items which are *not* deductible) and to assume tentatively that the remainder represents business expenses. With such an assumption in mind, examination of the charges composing this remainder often reveals deductible items not otherwise apparent.[18]

In the paragraphs which follow various items officially classified are cited as illustrative of allowable deductions. So long as good faith is observed in the inclusion of an expense item, it is not likely to incur criticism.

May personal expenses be deducted as casualties?—Section 215 provides that "no deduction shall in any case be allowed in respect of (a) personal, living or family expenses." But under deductions this statement appears:

LAW. Section 214. (a) That in computing net income there shall be allowed as deductions: . . . .

(6) Losses sustained during the taxable year of property not connected with the trade or business (but in the case of a nonresident alien individual only property within the United States) if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise. . . . .

It is claimed that the allowable deduction for a casualty to property "not connected with the trade or business" extends to losses sustained on private automobiles. If so, the deduction would also extend to the breakage of statuary and ornaments in one's home, to eyeglasses and perhaps to children's toys.

The author is of the opinion that section 215 is controlling as to all items which the taxpayer ordinarily regards as "personal, living or family expenses," and therefore section 214 (a-6) includes only losses arising from such casualties

[18] The remainder, determined in the negative manner thus described would, of course, not be an item acceptable to the tax authorities. The suggestion is made merely as a method of discovering deductible items which can be consolidated into a positive total of business expenses, suitable for use in the return.

as could not be regarded as personal, living or family expenses.[19]

Wages for personal service.—The law does not permit a deduction for wages paid to those in domestic service, nor to those, such as dressmakers and others, who produce articles consumed in the taxpayer's family, but wages paid to those who help to produce the income may be deducted. This rule is broad enough to include in most cases the salary of a private secretary. The distinction drawn in the 1918 edition of the *Income Tax Primer* is suggestive:

Ruling. I employ a man to assist me in operating my farm and a woman to assist about the house. Is the compensation paid to each allowable as a deduction?

Unquestionably, as to the amount paid to the male employee, but a line must be drawn as to the amount paid to the female employee. If her time is employed entirely in taking care of milk and cream produced for sale, in the production of butter, cheese, etc., the care of milk cans and churns, or, if a separate table is maintained for laborers employed on the farm and her services are used entirely in the preparation and serving of the meals furnished the laborers and in caring for their rooms, the compensation paid her constitutes an allowable deduction. If, however, she is employed to assist in caring for the farmer's own household, no deduction can be claimed. (*Income Tax Primer,* 1918, question 60.)

Wages paid to children.—

Regulation. . . . . Where the father is legally entitled to the services of his minor children, any allowances which he gives them, whether said to be in consideration of services or otherwise, are not allowable deductions in his return of income. . . . .[20] (Art. 291.)

The 1918 edition of the *Income Tax Primer,* in addition to affirming the above rule, makes the positive statement that compensation paid to a child who has attained his majority may be deducted if of the nature of a business expense.[21]

[19] For full discussion, see *Income Tax Procedure,* 1922, page 860 *et seq.*

[20] [Former Procedure] Article 8 of Regulation 33, 1918, reads: "As a rule, allowances which he gives them, ... are not allowable deductions . . . ." The present regulation is more emphatic in the denial of this item.

[21] *Income Tax Primer,* 1918, question 61.

Under the British practice, if any of the children or other relatives, except the wife, of a trader earn their livelihood in his employ, and if the trader provides their board and lodging as part of their remuneration, the expense thereof may be charged in his accounts as a trade expense irrespective of the age of the employee. On the other hand, if he withdraws some of his goods for domestic use, he should make an allowance therefor in his return of income.

Business expenses of the professional man.—Many lawyers, doctors and other professional men keep fairly accurate records of income, but are not careful to separate personal and living expenses from those incurred in producing their income. If care is taken to assemble all items of taxable income, equal care should be taken to compile a complete schedule of allowable deductions from income.

The official procedure in deducting professional expenses is outlined in the regulations in this language:

> REGULATION. A professional man may claim as deductions the cost of supplies used by him in the practice of his profession, expenses paid in the operation and repair of an automobile used in making professional calls, dues to professional societies and subscriptions to professional journals, the rent paid for office rooms, the expense of the fuel, light, water, telephone, etc., used in such offices, and the hire of office assistants. Amounts currently expended for books, furniture, and professional instruments and equipment, the useful life of which is short, may be deducted. . . . . (Art. 104.)

Under this new article professional men may deduct current expenditures for books, etc., if the life of such articles is short.

> RULING. Expenses incurred by doctors in taking post-graduate courses are deemed to be in the nature of personal expenses and not deductible. (C. B. 5, page 171; O. D. 984.)

Expenses incurred by school teachers attending summer school have been held to be personal.[22] A professional singer

[23] C. B. 4, page 209; O. D. 892; C. B. I-1, page 122; I. T. 1238.

may not deduct amounts paid to a specialist in the care of his throat.[23]

Depreciation on property "of a permanent character."—While expenditures for property "of a permanent character" may not be deducted as a business expense, depreciation allowances may be claimed with respect to almost all kinds of such property.

When office is in rented residence.—In case a professional man lives in a rented house and uses a portion of it for professional or business purposes the Treasury holds that the proportion of the rental paid which is chargeable to the rooms so used may be deducted as a business expense.

Regulation. . . . . In the case of a professional man who rents a property for residential purposes, but incidentally receives there clients, patients, or callers in connection with his professional work (his place of business being elsewhere), no part of the rent is deductible as a business expense. If, however, he uses part of the house for his office, such portion of the rent as is properly attributable to such office is deductible. . . . . (Art. 291.)

The above ruling, refusing to permit the deduction of a portion of the rent of a residence used partly for business purposes in case "the place of business" is elsewhere, appears to raise the question as to whether or not a professional man may have more than one place of business. The regulation apparently assumes in the phrase, "the place of business being elsewhere," that he can have only one place of business. As a matter of fact he may have several. In case the expenses of the additional quarters are "necessary" to the practice of the profession, they are certainly deductible under the law.

When office is in owned residence.—No definite ruling appears to have been issued covering the case of the professional man who owns his residence and uses part of it as his place of business, but there is no doubt about the pro-

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[23] C. B. 5, page 172; O. D. 1032.

priety of deducting in such a case the proper proportion of the depreciation, repairs, fuel, light, water, telephone, etc.

Traveling expenses.—

LAW. Section 214. [Individuals] **(a) That in computing net income there shall be allowed as deductions:**

(1) . . . . traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; . . . .

REGULATION. Traveling expenses, as ordinarily understood, include railroad fares and meals and lodging. If the trip is undertaken for other than business purposes, such railroad fares are personal expenses and such meals and lodging are living expenses. If the trip is solely on business, the reasonable and necessary traveling expenses, including railroad fares, meals, and lodging, become business instead of personal expenses. (*a*) If, then, an individual, whose business requires him to travel, receives a salary as full compensation for his services, without reimbursement for traveling expenses, or is employed on a commission basis with no expense allowance, his traveling expenses, including the entire amount expended for meals and lodging, are deductible from gross income. (*b*) If an individual receives a salary and is also repaid his actual traveling expenses, he shall include in gross income the amount so repaid and may deduct such expenses. (*c*) If an individual receives a salary and also an allowance for meals and lodging, as, for example, a per diem allowance in lieu of subsistence, the amount of the allowance should be included in gross income and the cost of such meals and lodging may be deducted therefrom. A payment for the use of a sample room at a hotel for the display of goods is a business expense. Only such expenses as are reasonable and necessary in the conduct of the business and directly attributable to it may be deducted. A taxpayer claiming the benefit of the deductions referred to herein must attach to his return a statement showing (1) the nature of the business in which engaged; (2) number of days away from home during the taxable year on account of business; (3) total amount of expenses incident to meals and lodging while absent from home on business during the taxable year; (4) total amount of other expenses incident to travel and claimed as a deduction.

Claims for the deductions referred to herein must be substantiated, when required by the commissioner, by records showing in detail the amount and nature of the expenses incurred.

Commuters' fares are not considered as traveling expenses and are not deductible. [Art. 101 (a).]

The 1921 law merely confirms a deduction which under any reasonable interpretation was fully allowable under all previous laws. Under the 1918[24] and prior tax laws, the regulations provided that the amount expended as business traveling expenses should be reduced by any saving of personal expenses, the reduced amount being a proper deduction from gross income. To properly determine any saving was a difficult task and a great inconvenience.

Traveling or other expenses incurred in rendering services by the taxpayer, which are afterward refunded to him, should be included in gross income and deduction claimed for actual expenses.

RULING. Amounts expended during the taxable year by a secretary to a Member of Congress and by his assistants for railroad fares, in making trips from their homes to Washington and return in connection with their duties, may be claimed as a deduction in computing their net income. Such expenditures incident to trips made for purely personal reasons are not deductible. (C. B. 4, page 212; O. D. 865.)

Expenditures for traveling other than in the pursuit of a trade or business are not deductible under any of the tax laws.

If a taxpayer who claims, say, $500, for five trips from New York to Chicago and return during 1921 is called upon for proof, it would probably be a sufficient compliance with the law to prepare an affidavit setting forth that the trips were exclusively on business, that the railroad fares were so much and that meals and other necessary expenses averaged so much a day. The test will be what a jury would allow, and it would not be necessary to produce vouchers because good business practice does not call for the securing of receipted bills for meals and similar expenses. The Treasury Department, however, is strict in requiring detailed information and will disallow deductions which cannot be reasonably supported. Compromises will apparently not be made.[25]

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[24] [Former Procedure] See Art. 292, Reg. 45, as amended by T. D. 3146. See *Income Tax Procedure*, 1921, pages 672, 673.

[25] C. B. I-1, page 119; A. R. R. 719.

RULING. A taxpayer engaged in a business in 1917 and 1918 which required him to spend a part of his time away from home but who failed to furnish the detailed information called for in article 292 of Regulations 45, 1920 edition, although requested to do so, is not entitled to claim as a deduction expenses incurred for meals and lodging in connection with carrying on such business. Treasury Decision 3101 amending article 292, Regulations 45, has been superseded by Treasury Decision 3146 (Regulations 45, 1920 edition), in which no mention is made as to the effective date of the provisions of article 292. (C. B. 5, page 172; A. R. R. 572.)

It has been held that a naval officer's expenses on permanent duty afloat are deductible if he has a home to which he may return. When he visits his home his expenses are not deductible as it is a personal expense. (I-46-590; I. T. 1497.)

TRAVELING EXPENSES WHICH ARE NOT DEDUCTIBLE.—

RULINGS. A Member of Congress may not deduct expenses incurred in making trips of a personal nature to and from Washington, the expense of taking members of his family to or from Washington, living expenses while in Washington, or campaign expenses. (C. B. 4, page 211; O. D. 864.)

Amounts expended during the taxable year for meals and lodging while in Washington by the secretary to a Member of Congress do not constitute traveling expenses within the meaning of section 214 (a) 1 of the Revenue Act of 1921 and are not deductible in his return of annual net income. (C. B. I-1, page 122; Digest I. T. 1264.)

Amounts expended by a physician for railroad and Pullman fares and hotel bills in attending a medical convention are not ordinary and necessary expenses incurred in the pursuit of his profession and do not constitute allowable deductions in his return. (C. B. I-1, page 123; I. T. 1369.)

Living expenses paid by a single taxpayer who has no home and is continuously employed on the road may not be deducted in computing net income. (C. B. 4, page 212; O. D. 905.)

The last quoted ruling is apparently no longer in effect, in view of the following:

RULING. Reference is made to your letters of April 10 and 25, 1922, asking for an interpretation of Article 101 (a) of Regulations 62 in the case of a taxpayer who maintains no home.

You are advised that there may be deducted by an individual engaged in a recognized commercial trade or business, but having no fixed place of abode, the amounts expended for meals and lodging during the taxable year while actually traveling in pursuit of his trade or business. There should be submitted in support of such claim a statement showing: (1) The nature of the business in which engaged; (2) the number of days during the taxable year actually spent in traveling on account of business; (3) the total amount of expenses incident to meals and lodging during the taxable year while traveling on account of business; (4) the total amount of other expenses incident to traveling and claimed as a deduction. (Letter to Prentice-Hall, Inc., signed by D. H. Blair, Commissioner, dated June 20, 1922.)

However, in a later ruling,[26] the Treasury holds that a taxpayer who travels continuously may only deduct the amounts spent for meals and lodging, if he "maintains a house or other living quarters to which he may at any time return, or which is at all times available for his use."

Ruling. . . . . Where a man makes a contract of employment with an employer in this country, and upon completion of such contract he makes a second contract with another employer in a foreign country, without allowance for travel expenses, the expenditure incurred in reaching such place of employment cannot be considered as an expense incurred in furtherance of a trade or business, but rather as an expenditure to fulfill a condition precedent to such employment in a trade or business and is therefore regarded as a personal expense and not deductible. The test is whether an expense is incurred primarily because of business as the immediate cause inducing the expenditure. (C. B. 2, page 157; O. D. 451.)

The foregoing ruling is questionable and certainly is not equitable. The expense is not the same as that of a commuter. The gross amount of the compensation to be collected in the foreign country is taxable. The cost of getting there arises from the income and would seem to be directly connected with that income. It is not a pleasure trip, but purely a business trip. If a business trip, the cost must be a necessary business expense and allowable under the law. In principle this expense is just as properly deductible as the expenses of a Congressman's secretary.[27]

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[26] I-45-580; I. T. 1490.

[27] See C. B. 4, page 212; O. D. 865, quoted on page 808.

Ruling. Advice is requested relative to the deductibility of amounts expended by a taxpayer in making a trip in search of work.

Held, that amounts expended by a taxpayer in seeking a position are held to be personal expenses and are not deductible from gross income for income tax purposes. (I-30-428; I. T. 1397.)

It is merely reiteration for the author to question rulings like the foregoing. It does not appear to interpret properly the law, which provides that taxpayers may deduct the ordinary and necessary expenses incurred in carrying on a business. The man out of work is just as much "in" business as the man who has a job but who neglects it, or the professional man who has no clients. A salesman working exclusively on commission during the first six months of a year might not earn a dollar. Technically, he is out of work and looking for work. Of course, his expenses are deductible from income subsequently earned. The man out of work would not deduct the expenses incurred in looking for work unless he had some gross income for the year from which to make the deduction. The law itself favors the idle rich. It is most unjust for the Treasury to misinterpret it to further penalize the industrious poor.

Personal expenses of army officers and government officials.—

Regulation. . . . . The cost of the equipment of an army officer to the extent only that it is specially required by his profession and does not merely take the place of articles required in civilian life is deductible. Accordingly, the cost of a sword is an allowable deduction, but the cost of a uniform is not.[28] (Art. 291.)

Ruling. Any amounts expended in purchasing furnishings and maintaining the residential portion of an embassy are considered

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[28] [Former Procedure] The above ruling reverses the procedure formerly in force. The previous practice, which operated very unfairly was prescribed in the following language:

Regulation. . . . . The pay and allowance of Army officers are based on the obligation of an officer to provide equipment and mounts as a personal expense. The cost of mounts and equipment is not therefore a deductible expense. . . . . (Reg. 33, 1918, Art. 8.)

For detailed criticism of this regulation see *Income Tax Procedure*, 1919, page 411.

personal expenses. Amounts expended in entertaining are likewise considered personal expense. While it is recognized that ambassadors do a certain amount of entertaining, Congress does not require it as one of the duties of the position or make specific appropriations for such entertainment. It is held that such expenditures are personal expenses and not business expenses, and are therefore not deductible. (C. B. 5, page 172; O. D. 1020.)

The foregoing ruling is not sound. The author hopes that it will be questioned by someone who, in order to perform his duties properly, has expended part of his salary for other than personal or family expenses. A business man deducts, and properly so, all similar expenses.

Rulings. A naval officer who is stationed in one locality for an indefinite period of time is not engaged in traveling in pursuit of a trade or business within the meaning of section 214 (a) 1, and the amounts expended by him for meals and lodging are in the nature of personal expenses and do not constitute allowable deductions in his income tax return. (I-31-439; I. T. 1404.)

Field officers of the Bureau of Internal Revenue may deduct the amounts expended by them for meals and lodging for such days as they receive per diem allowance. The amount of the allowance should be included in gross income. Office deputies or field officers having posts of duty and maintaining homes elsewhere may not deduct amounts expended for commuter's fares in traveling between such points, or for meals and lodging while at post of duty. Amounts so expended are personal expenses. (I-27-388; I. T. 1380.)

The living expenses in a foreign city where the taxpayer, an employee of the Red Cross, has a residence, maintaining one also in the United States, are held to be personal or living expenses which are not deductible in computing net income. (C. B. I-1, page 194; I. T. 1355.)

Where in 1918 an officer in the National Guard was required to handle the equipment issued to the men under him, and as a result of which he was required to pay to the State in 1921 a shortage in his property account not due to his negligence, he may deduct such shortage so paid as a loss incurred in his trade or business.

Any amount expended by him to purchase additional equipment for the men under him is a personal expense and not deductible. (C. B. I-1, page 142; Digest I. T. 1182.)

Clothing and personal equipment as a business expense.— Wherever clothing and other equipment, such as the uniforms

and instruments of musicians, constitute business expenses because not adaptable to private use, the cost thereof is an allowable deduction. To the extent that uniforms serve to diminish one's living expenses no deduction is proper, but if an additional expense is incurred solely to enable one to earn a living, this cost is nothing more or less than a necessary business expense. This rule is in harmony with the regulation regarding actors' costumes.[29] The following decisions are erroneous as the expenditures were obviously necessary to earn income.

Rulings. The taxpayer, a professional masseuse, gives treatments to patients in their homes and in hospitals as they are assigned to her by physicians or surgeons. She is required to wear a special uniform and to change her uniform after each treatment given. Held, that the cost of the uniforms and of laundering them constitutes a personal expense. (I-33-457; Digest I. T. 1419.)

Uniforms of nurses, railway trainmen, barbers, surgeons, and baseball players are held to take the place of ordinary clothing and the amounts expended by the wearer for the purchase of such uniforms are therefore held to be personal expenses, the deduction of which is specifically denied by section 215 (a) 1 of the Revenue Act of 1921. (I-44-572; I. T. 1488.)

Automobiles used in part for business purposes.—

Ruling. . . . . the Committee is unable to distinguish any essential difference between expenses incurred in travel by railroad and those incurred in travel by automobile, where such travel by either conveyance is undertaken solely on account of business interests and not for the personal pleasure of the taxpayer. Since railroad fares paid in connection with business trips are deductible as a necessary expense of the business, the Committee sees no reason why the expense of such trips, when made by automobile, should not fall within the same category. . . . .

It is, therefore, the opinion of the Committee that such portion of the upkeep and operating expenses of this taxpayer's automobile as was occasioned by its use in the taxpayer's business is a proper deduction as a business expense in the personal returns of the taxpayer. . . . . (C. B. 3, page 131; A. R. R. 266.)

Perhaps the item of expense most difficult to apportion between living and business is the upkeep of an automobile

[29] Art. 162.

which is used both for business and for personal purposes. In principle the test is apparently simple enough. "Personal, living or family" expenses are not allowable deductions. Business expenses are allowable deductions.

Premiums on certain insurance a personal expense.—

Regulation. Insurance paid on a dwelling owned and occupied by a taxpayer is a personal expense and not deductible. Premiums paid for life insurance by the insured are not deductible. . . . . (Art. 291.)

Ruling. Premiums paid by a taxpayer on insurance taken out under the War Risk Insurance Act, whether or not the insurance is subsequently converted, are not deductible in computing net income under the Revenue Act of 1918. (C. B. 4, page 208; Digest O. D. 828.)

Alimony and damages for breach of promise are not deductible.—

Regulation. . . . . Alimony and an allowance paid under a separation agreement are not deductible from gross income. . . . .[30] (Art. 291.)[31]

Expenses incurred on account of a partnership.—

Ruling. By the terms of a partnership agreement one of the members of the partnership is required to pay out of his own funds the compensation of one of the employees of the partnership who performs a part of the duties delegated to said member.

Held, that the amount so paid constitutes a proper deduction in the income tax return of the member under section 214 (a) 1 of the Revenue Act of 1918. (C. B. 4, page 137; O. D. 947.)

The above ruling under the 1918 law reverses a decision made by the Treasury under the 1917 law, wherein business expenditures by an individual made in behalf of the partnership were not allowed.[32] All expenses incurred by a partner in the furtherance of the business prospects or interests of a partnership of which he is a member (for which he has not

[30] *Gould v. Gould,* 245 U. S. 151, 38 Sup. Ct. 53, 62 L. Ed. 211.
[31] See page 367; also C. B. I-1, page 92; Sol. Op. 132.
[32] C. B. 3, page 130; O. D. 593.

been reimbursed) are deductible as being necessary business expenses. Certainly if such expenditures are made for the purpose of increasing the earnings of the firm, it cannot be said that they are personal expenses.

Salaries, Wages, Commissions and Similar Compensation

The authority for deducting salaries and wages is found in the following section of the law:

LAW. Section 214. **(a) That in computing net income there shall be allowed as deductions:**

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; . . . .

What constitutes reasonable compensation was a matter of great importance under the excess profits tax.[33] It is of little importance under the present law. The courts will decide that the allowance rests with those charged with the management of a business rather than with the Treasury. The factor of importance is good faith. The foregoing conclusion is justified by the following extract from a decision[34] of the court:

The presumption arising from the action of the board of directors was that it was all salary. In order to overcome this presumption the burden was on the Government to produce evidence, not necessarily conclusive, but sufficient to raise a valid inference that some definite part of the compensation was not salary but was profits.

Amounts ostensibly paid as compensation—Test of deductibility.—

REGULATION. Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of

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[33] For a full discussion of this subject including court decisions, regulations and rulings, see *Income Tax Procedure*, 1922, pages 870-890.

[34] *U. S. v. Philadelphia Knitting Mills Co.*, 273 Fed. 657. This case was under the 1909 law.

compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few stockholders, practically all of whom draw salaries. If in such a case the salaries are based upon or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries, if in excess of those ordinarily paid for similar services, are not paid wholly for services rendered, but in part as a distribution of earnings upon the stock. (*b*) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable in all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises in like circumstances. But if the salaries paid bear a close relationship to stock ownership, see paragraph (1) of this article. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.[35] . . . . (Art. 105.)

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[35] See Art. 32.

Treatment of excessive compensation.—

REGULATION. As to the treatment of amounts ostensibly paid as compensation, but not allowed to be deducted as such, the following rules apply:

(1) In the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stock holdings, the amount of the excess should be treated as dividends and would thus be exempt from the normal tax in the hands of the recipients.[36] If such payments constitute in part payment for property, the amount of the excess should be treated by the corporation as a capital expenditure and by the recipient as part of the purchase price.

(2) In the case of excessive payments by individuals or partnerships, the amounts disallowed should ordinarily be treated as shares of the profits of a partnership, except that a payment for property should be treated by the individual or partnership as a capital expenditure and by the recipient as part of the purchase price.[37] (Art. 106.)

The foregoing regulations are properly applicable whenever distributions of profits ostensibly as compensation have been made.

Bonuses and other special compensation.—Although the question of bonuses is in a general way covered by articles 105 and 106 of the regulations, quoted above, it is more specifically treated in the following paragraph:

REGULATION. Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. . . . . (Art. 107.)

This regulation accords with sound business practice. However, it has not been observed by all revenue agents. If a

[36] [Former Procedure] Art. 106, Reg. 45, contained a provision attempting to subject excessive payments to normal tax in the hands of the recipients.

[37] [Former Procedure] T. D. 2696, April 10, 1918, which covered most of the points contained in articles 105 (see page 815) and 106, above quoted, also provided:

"If a compensation contract with the majority stockholder or stockholders is approved by all the stockholders, as well as by the directors, it might, however, be dealt with like any other contract."

taxpayer believes that deductible items have been disallowed an appeal should be made to the Commissioner, who can be depended upon to confirm the regulation just quoted.

The question of reasonableness is one which must be left, in most cases, to the directors of a corporation. A bonus may appear to be unreasonable, but if paid in good faith it becomes a necessary business expense.

In the opinion of the author the courts will not disallow any compensation, no matter how unreasonable it appears to be on the surface, and no matter how large it seems to be when compared with the amounts paid by other concerns, unless the payment is proved to be merely a division of profits distributed proportionately to stockholdings.

Contingent salaries are deductible in the year paid.—

RULING. When additional compensation is agreed to be paid by a corporation to its officers at a future date, upon the happening of certain contingencies expected to result from the rendition of services, the amount of such compensation being left for future determination, the amount eventually so paid is not to be treated as back salary and allocated to the years during which the services were rendered, but constitutes a business expense to the corporation for the taxable year in which the same was paid. (C. B. 3, page 142; Digest A. R. R. 232.)

Salaries may be determined after close of fiscal year—when?—

RULINGS. The compensation of the officers of a corporation had been continued without change for several years. In 1919, two days before the close of its fiscal year, the salaries of the principal officers of the corporation were largely increased for the year then closing.

Section 234 (a) of the Act of 1918 provides that in computing the net income of a corporation subject to tax there shall be allowed as deductions all ordinary and necessary expenses paid or incurred during the taxable year, including a reasonable allowance for salaries. The authorization to increase the salaries in question occurred before the books were closed for the fiscal year, and as such became a liability of the corporation for that year. If the compensation thus authorized was reasonable the total amount is an allowable deduction. (C. B. 2, page 111; O. D. 504.)

The Committee recommends the disallowance of additional compensation claimed by a corporation as a deduction for 1917 where such additional compensation was not as a matter of fact authorized or paid until 1919 and that such additional compensation be allowed as a deduction under the heading of ordinary and necessary expenses in the taxpayer's return for the year 1919 in which year the payment was actually made. (C. B. 4, page 134; Digest A. R. R. 519.)

In this case the secretary-treasurer of a corporation performed all of the executive duties of the president during the latter's illness in 1917, but due to a combination of circumstances it was not possible to pass the appropriate additional compensation resolution until 1919.

"Christmas gifts."—Regulations 62 do not specifically discuss the deductibility of the "Christmas gifts" which so many business houses are accustomed to distribute to employees each year. The reasoning of article 105 would indicate that such payments to employees are deductible so long as the total compensation, including such payments, "is only such amount as would ordinarily be paid for like services by like enterprises in like circumstances." However, it may be that the Treasury expects to classify these payments in the category of "donations" as defined in the following paragraph.

Regulation. . . . . Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are considered gratuities and are not deductible from gross income. (Art. 107.)

In the author's opinion the Treasury, in the matter of Christmas gifts and similar items, has not always interpreted the law properly. Most Christmas gifts to employees are wages, pure and simple. Particularly where the gifts are large, an employee, on being asked the amount of his compensation for the year, will in his answer name a figure which includes the "gifts." This is not a theory. It is standard business practice to include items of this kind as one of

the necessary business expenses intended by the framers of the law to be an allowable deduction.

Educational and "welfare" outlays for employees.—It is now considered advantageous for an employer to educate and stimulate his employees in all matters relative to the business and to promote their development so that they may become more useful and valuable. Schools are founded, classes are formed, lecture courses are arranged, gymnasiums are opened, athletic games are encouraged, entertainments are provided, and many other ways are found of carrying out the purpose in view. Some of these plans appear to be altruistic and of a semi-charitable nature. When this idea is uppermost, the cost of the ventures should be entered on the books as gifts or donations.

If, as is often the case, the controlling motive is the betterment of the business, the cost is a business expense, pure and simple, even though the results are disappointing. In these days of labor and other administrative troubles, the cost of any practical and effective plan of improving the moral, mental and physical condition of employees is a practical business expenditure. It is not a charitable scheme. It is a money-making, not a mere money-spending, proposition. In the opinion of the author such expenses are allowable deductions and may be so claimed.

Ruling. Inquiry is made whether the following are allowable deductions in the income tax returns of a taxpayer:

(1) Amounts expended in outfitting a baseball team which represents the taxpayer, and the uniforms of which bear the name of the taxpayer the players represent.

(2) Expenses incurred in furnishing entertainment to the taxpayer's employees by means of picnics or dances.

Inasmuch as it appears that the name of the taxpayer is given considerable publicity in the appearance of the taxpayer's baseball team in various parts of the district in which the taxpayer does business and by a report of the games in the newspapers of the vicinity, it is held that the expenses incurred relative to the outfitting and support of the ball team representing the taxpayer are similar to

those expended in other methods of advertising and are deductible as business expenses in the income tax returns of the taxpayer.

However, expenses incident to the furnishing of entertainment to the employees by means of picnics or dances are not such "ordinary and necessary" business expenses as are comprehended by the Revenue Act of 1918, and therefore are not allowable deductions from gross income for purposes of computing income tax. (C. B. 5, page 120; O. D. 1030.)

The author is of the opinion that the latter part of the foregoing ruling is unsound. Such entertainments contribute to a finer *esprit de corps,* which in turn is reflected in the productivity of the business. If the directors believe that the expenses are necessary, the burden of proof is on the Treasury to show that they are not.

Ruling. Where a corporation encourages or requires its employees to attend part-time schools it may deduct as a business expense reasonable amounts paid as compensation to such employees during their absence from employment while attending such schools.[38] (C. B. 4, page 130; O. D. 850.)

Pensions to ex-employees and their dependents.—

Regulation. Amounts paid for pensions to retired employees or to their families or others dependent upon them, or on account of injuries received by employees, and lump-sum amounts paid or accrued as compensation for injuries, are proper deductions as ordinary and necessary expenses. Such deductions are limited to the amount not compensated for by insurance or otherwise. No deduction shall be made for contributions to a pension fund held by the corporation, the amount deductible in such case being the amount actually paid to the employee. When the amount of the salary of an officer or employee is paid for a limited period after his death to his widow or heirs, in recognition of the services rendered by the individual, such payments may be deducted. . . . . (Art. 108.)

This regulation recognizes that the total payments to employees themselves or to their dependents are allowable deductions.[39] It is open to criticism, however, because of its re-

[38] See C. B. I-1, page 72; I. T. 1304, as to the inclusion in income of the students of tuition fees paid for them.

[39] [Former Procedure] The procedure in regard to the deductibility of pensions paid to dependents of employees has had a checkered history. T. D. 2090 provided that:

Regulation. Amounts paid for pensions to retired employees, or

fusal to permit the deduction of amounts set aside during accounting periods as accruing expenses. The regulation is inconsistent with other regulations which permit deductions for liabilities incurred but not paid. Amounts appropriated to pension funds are supposed to approximate the liabilities which attach to all pension plans. Obviously in many cases actual payments are deferred, but if it can be shown that the contributions to a fund are not in excess of the reasonable requirements of the pension plan, applicable to the employees on the payrolls during the period in question, the entire contribution is clearly a necessary expense of the business.

CONTRIBUTIONS TO PENSION FUNDS WHICH ARE DEDUCTIBLE.—

RULING. Donations by a corporation to a pension fund for the benefit of its officers and employees, the fund being organized entirely separate and distinct from the corporation, having its own set of books, making its own investments, and paying its own expenses, legal title of which does not remain in the corporation, are deemed to be donations to a charitable institution conducted for the benefit of the corporation's employees or their dependents representing a consideration for a benefit flowing directly to the corporation as an incident of its business and are allowable deductions from gross income in determining net income subject to tax. (C. B. 1, page 224; O. D. 110.)

Commissions of various types.—

COMMISSIONS PAID TO SALESMEN AND COMMISSIONS ON INSURANCE PREMIUMS DEDUCTIBLE.—

REGULATION. . . . . Commissions paid salesmen, ... commis-

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to their families, or others dependent upon them, or on account of injuries received by employees, are proper deductions as ordinary and necessary expenses.

However, the 1918 edition of Regulations 33, articles 136 and 137, took the position that:

REGULATION. When the amount of the salary of an officer or employee is paid for a limited period after his death to his widow or heirs, in recognition of the services rendered by the individual, no services being rendered by the widow or heirs, such payment is not "ordinary and necessary" expense of transacting business and does not constitute an allowable deduction.

This was once more reversed by Reg. 45, Art. 108. Art. 108 of Reg. 62 is the same as in Reg. 45.

sions on insurance premiums, ... are income to the recipients; . . . . (Art. 32.)

Consequently they are deductible as compensation for services.[40]

MANAGEMENT COMPENSATION OR COMMISSIONS PAID AGENTS DEDUCTIBLE.—An old Treasury decision specifically states that:

RULING. A commission paid to a real estate agent for collecting rents and for management of property, is a legitimate business expense and constitutes an allowable deduction in computing net income. (T. D. 2090.)

The same rule would apply to the charges of trust companies or other agents who collect income and manage personal as well as real property.

As the recipient of the income usually receives and enters a net amount, he frequently fails to record the items of gross income and deductions therefrom. Where part of the income is from dividends or tax-free covenant bond interest this method results in a loss of the credits for normal tax. When all the items of income are entered gross, there should also be entered as deductions the expenses which are applicable to the income.

COMMISSIONS PAID TO STOCKBROKERS NOT DEDUCTIBLE AS EXPENSES.—

REGULATION. . . . . Commissions paid in purchasing securities are a part of the cost price of such securities. Commissions paid in selling securities are an offset against the selling price. . . . . (Art. 293.)

When securities are sold the profit is decreased or the loss is increased by the commissions charged. Therefore the amounts paid in such commissions are fully deductible eventually.

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[40] See page 420.

Commissions paid to parent company deductible.—

Ruling. In the computation of taxable income for income tax purposes only there should be allowed as deductions in the nature of ordinary and necessary expenses of business certain commissions paid, pursuant to valid agreements, to a parent corporation by its subsidiary corporations in consideration of contract work allotted to the subsidiaries by the parent corporation. . . . . (C. B. I-1, page 331; Digest A. R. R. 907.)

This ruling was issued under 1917 law, which explains the restriction "for income tax purposes only." The deduction would not be effective between corporations affiliated for excess profits tax purposes under the 1917, nor to corporations affiliated under the 1918 law. However, the ruling applies where consolidated returns are not made under the 1921 law.

Compensation paid in stock deductible. —

Regulation. . . . . Compensation paid an employee of a corporation in its stock is to be treated as if the corporation sold the stock for its market value and paid the employee in cash. . . . . (Art. 33.)

Ruling. Shares of stock issued to an officer of a corporation in consideration of services rendered as such officer and his assistance in obtaining loans, when such loans were required, through his personal indorsement of the notes of the corporation, constitute an allowable deduction in the return of the corporation for the taxable year in which paid. The amount of such deduction will be the market value of the stock at the time of delivery. (C. B. I-1, page 269; Digest I. T. 1197.)

Stock issued to employees for services.—During recent years many concerns have sold stock to their employees so that they may participate in the profits of the business. Generally, these sales are made on an instalment plan, the company crediting a small amount each year to the employee, which is applied to the purchase of the stock. The employee also pays a small amount every week or month, which is likewise applied against the purchase price of the stock.

The amounts which the company credits to the employee are for services rendered and are deductible as a necessary business expense.

Rulings. A proportionate part of the par value of a company's stock delivered to a trustee to be held in escrow for the benefit of certain employees of the company which stock is to be delivered to them at the expiration of a number of years in recognition of faithful service, may be taken as a deduction in the income tax returns of the company for each of such years during the period the trustee holds the stock, providing the corporation keeps its books on an accrual basis.

If the employee for whom the stock was deposited should forfeit his right to receive the stock, the corporation must report as income in the year in which the right to receive the stock is forfeited, the amounts taken as a deduction in previous years on account of the forfeited stock. (C. B. 1, page 107; O. D. 124.)

If a corporation distributes shares of its treasury stock to its employees as additional compensation, the market value of the stock at the time of distribution is deductible by the corporation. Any difference between such market value of the stock and its cost to the corporation is neither taxable gain nor a deductible loss to the corporation. (C. B. 4, page 137; Digest A. R. M. 114.)

This ruling depends on the fact that no taxable profit or deductible loss can arise from transactions engaged in by a corporation in its own treasury stock. Had it distributed stock in some other corporation owned by it, the difference between cost and market price would be a taxable profit or deductible loss, as the case might be.

Compensation to employee of a partnership under a participation of profits agreement deductible.—

Regulation. . . . . compensation for services on the basis of a percentage of profits . . . . [is] income to the recipients; . . . . (Art. 32.)

It follows, of course, that the payment constitutes an item of business expense to the partnership.

Partners' and sole proprietors' so-called salaries.—Since the disappearance of the excess profits tax, the designation of salaries for partners or proprietors has become essentially an artificial and pointless practice so far as the determination of taxable income is concerned. Withdrawals made by individuals or partners from a business in which they own all or part

of the capital are normally in anticipation of profits. As between partners, salary allowances may serve to adjust or define distributions of profits or sharing of losses, but merely calling such drawings expenses does not make them so.

In the language of the Treasury:[41] "Wages or salary drawn by a taxpayer from his own business are more in the nature of a charge out of profits than a charge against profits. If such could be deducted they would merely be added to his income, the effect of which would be to take money out of one pocket and put it in another."

Insurance

Life insurance premiums paid by insured not deductible.—

REGULATION. . . . . Premiums paid for life insurance by the insured are not deductible. . . . . (Art. 291.)

RULING. Where a corporation insures the life of its president, the stockholders being beneficiaries in proportion to their stock holdings and the wife of the president (not herself a stockholder) being a beneficiary in proportion to her husband's stock holdings, no deduction for the payment of premiums can be allowed under article 294 of Regulations 45, as amended by T. D. 3019, since the corporation itself is indirectly a beneficiary under the policy.

The premiums paid on such a policy are a charge against surplus and represent dividends to the stockholders subject to surtax to the extent that such premiums are paid out of earnings or surplus accumulated since February 28, 1913. This applies as well to the officer upon whose life the insurance is carried. (C. B. 3, page 192; O. D. 659.)

Though no part of the proceeds of the policy would be paid to the taxpayer (the corporation), the Treasury ignores the corporate entity in the foregoing decision. The decision is sound, however, from an equitable if not from a legal point of view. However, when the equity is in favor of the taxpayer the Treasury finds it difficult to look through the corporate entity.

Whether or not the deduction of life insurance premiums of this type should be permitted resolves itself very largely

[41] *Income Tax Primer*, 1918, question 62.

into a question as to whether or not the degree of security of a source of income shall be taken into account in levying a tax on the income from that source. For example, shall income from personal effort, which may suddenly be terminated at the death of the producer, be given some concession compared with "funded" income? In England, where this question is of long standing,[42] the earned incomes are not only taxed at lower rates but premiums on insurance on one's own life or that of his wife are deductible up to one-sixth of the net income.[43]

At the time the 1913 law was passed Judge Hull explained that no deduction was permitted for such expenditures because the exemption was large enough to cover them. The exemption was materially lowered in the 1917 law, but no deduction was provided for life insurance premiums.

"Business" life insurance premiums not deductible.[44]—

LAW. Section 215. [Individuals and corporations—items not deductible] . . . . (a) . . . . (4) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy. . . . .

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[42] Seligman, *The Income Tax,* 2nd Ed., 1914, pages 79, 133, 154-155. After first permitting the deduction and then forbidding it, the permission was firmly established in the law in 1853.

[43] Murray and Carter, *A Guide to Income Tax Practice,* 8th Ed., page 259. The allowance, however, is "not admissible as a deduction in arriving at the total income for the purpose of a claim for relief in respect of 'earned income.'"

[44] [Former Procedure] Under T. D. 2090 (December 14, 1914) premiums on such insurance were deductible, but when the policies matured or upon the death of the insured the amount received was reportable as income. This procedure was changed by T. D. 2519 (August 30, 1917) which forbade the deduction of the premiums annually but provided instead that they might be cumulated and deducted from the gross proceeds, when received, of any policies of which the business concern was the beneficiary. As applied to term policies for special purposes, if there was no surrender value, the premiums represented a business expense and credit should have been claimed therefor. The test of deductibility prior to 1917 should rest on reasonable protection to a business as against

"Group" insurance premiums are deductible.—The law disallows deductions for premiums only when the taxpayer is a beneficiary. So-called "group" insurance premiums are deductible because the proceeds of the policies are paid to someone other than the taxpayer.

Regulation. . . . . If, however, the taxpayer is in no sense a beneficiary under such a policy, except as he may derive benefit from the increased efficiency of the officer or employee, premiums so paid are allowable deductions. . . . .[45] (Art. 294.)

Accident insurance premiums.—The 1921 law[46] and regulations[47] hold that proceeds of accident insurance policies are not taxable income. Therefore premiums paid for accident insurance are not allowable deductions. The controlling reason for taking out accident insurance is to secure special income in case one's regular income is shut off. It would

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investment or profit possibilities. If the premiums paid merely provided for reimbursement of possible business losses by fire or death of a valuable executive, or against any true business risk, the cost of insurance was correspondingly a true business expense.

1917 Law. Section 32. "That premiums paid on life insurance policies covering the lives of officers, employees or those financially interested in any trade or business conducted by an individual, partnership, corporation, joint-stock company or association, or insurance company, shall not be deducted in computing the net income of such individual, corporation, joint-stock company or association, or insurance company, or in computing the profits of such partnership for the purposes of subdivision (e) of section eight (3)."

A possible explanation of the insertion of section 32 in the law in 1917 is the desire to prevent evasion. It is conceivable that in a year of high tax rates a concern might reduce its taxes by insuring heavily various persons associated with the business. Evasion would be particularly easy if the various types of "investment" insurance were available.

The provision of the 1918 law was inserted in the 1921 act without change.

[45] In an early edition of Regulations 45, this sentence read as follows: "But if the taxpayer is in no sense a beneficiary under such a policy, except as he may derive advantage from the increased efficiency of the employee, and pays the premiums purely as reasonable additional compensation of such employee, they are allowable deductions."

[46] Section 213 (b-6).

[47] Art. 72.

therefore seem logical to tax the income and allow credit for premiums paid and for any unusual expenses arising from the contingency giving rise to the payment of the insurance.

In the case of a business, however, such premiums are deductible.

Property insurance premiums—when deductible.—

REGULATIONS. . . . . Other items that may be included as business expenses are . . . . insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business. . . . . (Art. 101.)

Insurance paid on a dwelling owned and occupied by a taxpayer is a personal expense. . . . . (Art. 291.)

In conformity with these rulings, premiums on insurance covering a dwelling house occupied by the owner may not be deducted. On the other hand, if the insurance covers a barn on a farm it is deductible.

Premium on fidelity bonds deductible.—

RULINGS. Where an employee is required to furnish bond and pay the premium on such bond as a necessary incident to his employment, the premium on the bond will constitute an allowable deduction in computing net income. (T. D. 2090.)

Premiums paid on indemnity bonds furnished by Government employees for the faithful performance of their duties constitute allowable deductions in computing net income for the purpose of the income tax. (C. B. 4, page 124; O. D. 878.)

If the premium is paid by the employer, the payment is likewise deductible as a business expense.

Premiums paid on insurance policies to secure loans.[48]—In a recent opinion the Solicitor of Internal Revenue held that:

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[48] [Former Procedure] Premiums were held deductible when a taxpayer was required to take out life insurance in favor of the lender as security for a business loan (C. B. 2, page 104; O. D. 396), even though the policy was taken out after the loan was made (C. B. 5, page 119; O. D. 1011); but these rulings were to be strictly construed (C. B. 3, page 139; O. D. 711). The deduction was also allowed when a policy was taken out as security on the renewal of a loan for the full amount, but only partially when the renewal was for less than the full amount of the original loan

A corporate or individual taxpayer who takes out a policy of life insurance in favor of a lender in order to procure a loan is not entitled to deduct the premiums paid on such policy if, in the event of payment of the proceeds, such proceeds will be applied in satisfaction of the obligation of the taxpayer.[49]

In view of section 215 (a-4) the foregoing opinion is sound. It is improper to permit the deduction of insurance premiums by one taxpayer and deny the deduction to another. In some cases, section 215 (a-4) may work a hardship, but so do other sections. One taxpayer may be required by a lender in good faith to take out a policy and the premium may increase business expenses without increasing income. Another taxpayer who contemplates insuring his life for the benefit of his estate could evade the law (under previous rulings) by requesting his bank to "require" him to take out the insurance and ostensibly apply the proceeds to the payment of debts.

Are premiums deductible by lender?—Assume that A is indebted to B and assigns his policy of life insurance to B. A is unable to continue paying the premiums and B pays them. May B deduct such premiums in his return?

Practically all of the rulings deal with cases where the premium was paid by the insured [except cases of business life insurance under section 215 (a-4)]. But it is apparent that in the illustration above, B in paying the premium is merely making an expenditure to secure collection of the debt. Collection expenditures are deductible.

"Self-insurance" reserves.—

Regulation. Funds set aside by a corporation for insuring its own property are not a proper deduction, but if such funds are set aside, or a reserve therefor is set up, any loss actually sustained and charged to such funds or reserves may be deducted. (Reg. 33, 1918, Art. 144.)

(C. B. 4, page 123; O. D. 843). Premiums were held deductible when a policy was taken out to retain partners in a business venture as long as the proceeds were not used to satisfy any obligation of the insured. (C. B. I-1, page 119; I. T. 1340.)

[49] C. B. I-1, page 197; Sol. Op. 136.

If the amounts set aside are simply equal to the premiums charged by an insurance company it is quite possible that the courts would decide that such reserves or provisions against losses would be allowable deductions as business expenses. Certainly sound accounting practice requires that such items should be charged to an expense account.

Prior to 1922 the Treasury held that the total compensation awarded by industrial commissions of states could not be deducted at the time of determination, but that only the actual amounts paid during each year could be deducted. The author expressed the opinion that the position of the Treasury was not in accordance with good accounting practice and would eventually be modified. This has been done in the following ruling which accords with good accounting practice.

Ruling. A partnership, which keeps its books on an accrual basis, is required to pay to an injured employee a sum in weekly installments extending over a period of several years, such sum being fixed by the industrial commission of the State wherein the partnership is located.

The question is raised as to whether the total award may be deducted in computing net income for the year in which the award was made, or whether the amount covered by the commission's finding is in the nature of a deferred liability ascribable as a deduction to a subsequent taxable year or years.

It is held, that the entire amount of the compensation award made by the industrial commission of the State may be deducted in the taxable year in which the award was made. As the partnership books were kept on an accrual basis, the full amount of the compensation award became an accrued liability at the time it was determined by the industrial commission. (O. D. 686, C. B. 3, page 148; O. D. 992, C. B. 5, page 118; and O. D. 1123, C. B. 5, page 133, revoked.) (C. B. I-1, page 123; I. T. 1263.)

Credit insurance deductible.—A recent ruling holds that premiums paid for the insurance of accounts receivable may be deducted as a business expense.[50]

Insurance reserves to equalize profits not deductible.—Representatives of the canning industry asked that the Treas-

[50] C. B. I-1, page 113; A. R. R. 723.

ury permit the deduction of reserves for possible *future* losses.[51] The Treasury denied the request on the ground that it was "in effect a proposal to equalize profits in a manner not contemplated by the Act."

The Treasury has held,[52] that if insurance has actually been taken out, the premiums are deductible as necessary business expenses. This perhaps is a way out of the difficulty, as it should be possible for each industry to organize an insurance company.

The 1921 law[53] grants the relief sought, at least in part, by a different method. Losses of one year may be carried forward one or two years.

Insurance under workmen's compensation laws.—Premiums paid to insurance companies or state insurance commissions by employers under workmen's compensation laws are deductible. Even though these laws permit an employer to establish reserves for the purpose of carrying the risk himself, such reserves cannot be deducted, but payments to employees from such reserves are deductible.

Ruling. Under the Workmen's Compensation Law of a State, employers are required either to make periodical payments to the State Insurance Fund created to compensate employees for injuries received in the course of their employment, or to maintain a benefit fund providing for the payment of such compensation, giving a bond as additional security for the payment of such compensation.

Where the employer makes the periodical payments to the insurance fund of a State such payments are allowable deductions for the year in which paid or accrued.

If, however, the employer maintains a fund actually depositing periodically in a trust company an amount to be held in reserve as a special fund for the payment of compensation as injuries occur, the amount thus deposited is not an allowable deduction from gross income, since there is no means of determining how much of this fund will be used for the purpose for which it is held. In such case the actual amount paid during a year to the employees as compensation

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[51] For text of request see *Income Tax Procedure*, 1922, pages 900-901.
[52] C. B. 1, page 104; O. D. 215.
[53] Section 204.

where injuries occur is a proper deduction for that year whether the amount so paid is greater or less than the deposits made during the period to the fund which is maintained. (C. B. 5, page 118; O. D. 964.)

Assessments for insuring bank deposits.—

Regulation. Banking corporations, which pursuant to the laws of the States in which they are doing business, are required to set apart, keep, and maintain in their banks the amount levied and assessed against them by the State authorities as a "Depositors' guaranty fund," may deduct from their gross income the amount so set apart each year to this fund, provided that such fund, when set aside and carried to the credit of the State banking board or duly authorized State officer, ceases to be an asset of the bank and may be withdrawn in whole or in part upon demand by such board or State officer to meet the needs of these officers in reimbursing depositors in insolvent banks, and provided further that no portion of the amount thus set aside and credited is returnable under the laws of the State to the assets of the banking corporation. If, however, such amount is simply set up on the books of the bank as a reserve to meet a contingent liability and remains an asset of the bank, it will not be deductible except as it is actually paid out as required by law and upon demand of the proper State officers. (Art. 567.)

Where insurance is taken out by a corporation on the life of the guarantor of a debt to the corporation, the surrender value of the policy can not be included in invested capital but the premiums paid may be deducted as a business expense.[54]

Rulings. An assessment paid by a State bank in Texas, operating under the depositors' guaranty fund plan, to the State banking board or credited to the account of such board, is a necessary business expense incurred by the bank in doing a banking business and is deductible as such in computing the net income of the bank subject to tax. (C. B. I-1, page 281; Digest I. T. 1258.)

The assessments which a State banking corporation in North Dakota are required to pay over or credit on its books to the depositors' guaranty fund are deductible by the bank as a business expense in computing its net income subject to tax. (C. B. I-1, page 283; Digest I. T. 1332.)

Amounts paid by a State bank in South Dakota under sections 9005-9031 of the Revised Code of 1919 to the depositors' guaranty fund are deductible from gross income. (I-43-564; Digest I. T. 1481.)

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[54] C. B. 5, page 177; O. D. 1109.

Reserves for Discounts

In certain industries, notably textiles and leather, it is a general custom to allow high rates of discount for payment in thirty days. These rates may be as high as 4, 6, 7 or 10 per cent. Manifestly customers cannot afford not to avail themselves of discounts at these high rates; in fact a manufacturer would decline to do business very long with any customer who did not make it a practice to pay such bills within thirty days. When the rate of discount is only 1 or 2 per cent, the issue is not of very great importance, but when the rates are higher the amount of tax may be materially affected by whether deduction is claimed for the amount of discount actually taken by customers or for the amount of discount which will be deductible upon prompt settlement of the accounts.

The manufacturer recognizes that the face amount of the invoice carrying a high rate of discount should be reduced by the amount of discount in order that his accounts may reflect true income. This is ordinarily accomplished by establishing a reserve both at the beginning and at the end of the fiscal year to offset the amount of discount included in the accounts receivable. A manufacturer who determines his income on the basis of discounts actually taken without allowance for the increase or decrease in the discounts on outstanding accounts receivable is misleading himself.

The Treasury heretofore has refused to recognize the regular accounting procedure involved in setting up appropriate reserves for cash discounts. In 1919 it held that such discounts as had actually been deducted by customers prior to the date of filing the return, could be deducted, but this permission was an unsatisfactory compromise.

The following ruling outlines the present procedure of the Treasury.

Ruling. Section 212 of the Revenue Acts of 1918 and 1921 provides that the net income shall be computed in accordance with the method of accounting regularly employed in keeping the books of the

taxpayer. Good accounting practice sanctions two methods of dealing with cash discounts. Under the first, the seller in setting up accounts receivable, currently sets up a reserve for the amount of cash discounts allowable. In such case he reports each year the amount of his sales less the cash discount allowable. Under the second method the seller sets up no reserve but reports the gross amount of his sales, taking as a deduction therefrom the actual discounts allowed during the current year, and in the following year he takes a deduction in respect of any discounts allowed upon outstanding accounts at the close of the preceding year. These two methods should be recognized by the Bureau and the taxpayer allowed to make his income tax return accordingly if he consistently follows either method.

The following should be accepted as guidance in matters of this kind:

Where a taxpayer regularly sets up a reserve for the amount of cash discounts allowable, he should return each year the amount of his sales less the cash discounts allowable. Any portion of such discounts collected in subsequent years should be returned as income when collected. Where the taxpayer sets up no reserve for cash discounts but regularly reports the gross amount of his sales, he should take as a deduction from gross sales the amount of the discounts actually allowed during the year for which return is made. Any discounts allowed in the following year on outstanding accounts at the close of the preceding taxable year should be taken as a deduction in the year in which allowed. Under no circumstances will the taxpayer be allowed to throw back into the prior year discounts actually allowed after the close of that year.

O. D. 146 (C. B. 1, page 221) overruled. (C. B. I-1, page 51; I. T. 1348.)

The foregoing ruling provides that reserves may be "currently" set up for discounts. This has been construed by the Treasury to mean that the accounting system must include continuous provision for the allowable (not allowed) discounts, and that it is not sufficient to adjust the reserve once a year in closing the books.

Rebates on Sales

Under the Revenue Act of 1918 a specific provision was made for the deduction from *net income* for the taxable year 1918 of actual payments of rebates made after the close of that year in pursuance of contracts entered into during such

year upon sales made during such year. [See 1918 law, section 214 (a-12). Claims for abatement were to be filed, carrying interest at 1 per cent a month on any amount subsequently disallowed.]

It has been held that such rebates were deductible only when the payments were made (a) in pursuance of contracts entered into during the year 1918, and (b) upon sales consummated during that year. (C. B. 1, page 155; A. R. M. 4: C. B. 5, page 162; A. R. R. 590: C. B. 2, page 155; A. R. R. 155.)

This provision was not re-enacted in the Revenue Act of 1921. However, in view of section 214 (a-6) which allows losses to be allocated to the year in which sustained, rebates are deductible under the present law, although there is no specific provision regarding them.

The question of the year in which rebates are deductible depends largely on the business relationship between buyer and seller or on the contract of sale. When a definite liability exists at the end of a fiscal period, even if the amount is not ascertained at the moment but is capable of computation on a prearranged basis, there can be no doubt as to the deductibility.

Ruling. A corporation during its fiscal year ended May 31, 1919, sold certain goods, the weight and grade of which were guaranteed by contract. At the close of that fiscal year a number of claims involving shipments not conforming to specifications were in process of adjustment, settlement of which was made during the ensuing fiscal year.

Inasmuch as the corporation's liability is not in dispute and the amount thereof is merely an accounting detail to be determined under an existing contract or agreement and in accordance with a recognized method of procedure the Committee is of opinion that such adjustments are applicable to the year in which the sales were made and hence properly deductible in the return of the corporation for its fiscal year ended May 31, 1919. (C. B. 3, page 147; Digest A. R. R. 275.)

When goods are sold under a contract warranting quality, etc., or under an agreement to protect the price if reduced, then any rebates should be applied against the year in which the sales were consummated.

Ruling. During the latter part of the year 1917 a corporation received claims from dealers who claimed that the product sold by the corporation and purchased by them was not as represented and that, under the warranty contract, they were entitled to return the product and have the purchase price refunded. The corporation did not deny its liability under the express warranty and in 1918 actually paid back the purchase price.

Held, that the corporation be permitted to accrue as a liability and deduct from gross income the amount of refunds or credits made to customers in 1918 to the extent that claims were filed by customers and admitted by the corporation within the taxable year ended December 31, 1917, and that the remainder of the total of such refunds or credits be allocated to the year 1918, in which year the claims covering the remainder of such refunds or credits were actually made. (Also sec. 213(a), art. 51; sec. 203, art. 1584.) (C. B. I-1, page 126; Digest A. R. R. 921.)

In view of the warranty contract, the whole loss should have been applied against 1917 income.

Ruling. Section 214(a)12 of the Revenue Act of 1918 gives to any and all taxpayers the right to a deduction of rebates made in 1919 pursuant to sales contracts entered into and consummated in 1918.

One of the conditions of every contract for sale entered into by the taxpayer during the taxable year of 1918 was a usage or custom existing in its trade or business of paying rebates on decline of the price of its product. The Committee holds the opinion that an oral contract or a contract implied from past dealings of the taxpayer and from the usages and customs of the trade in general can not but be interpreted as included in the scope of the word "contract" as used in the above section; that the rebate payments made by the taxpayer in 1919, having been made in discharge of these actual contractual liabilities which the taxpayer could not escape, constituted the payment of "rebates in pursuance of contracts entered into" during the taxable year 1918. (C. B. 5, page 162; Digest A. R. R. 590.)

Under the 1917 law, rebates under contracts to protect declining prices were held deductible only in the year determined. (C. B. 5, page 254; Digest A. R. M. 136.) Under the present law, such losses should be deducted in the year of sale.

Rentals

No difficulty arises concerning ordinary rentals paid in cash in business operations. Sometimes, however, the rental

charge is increased by expenditures not included in the cash payments to the landlord. These, of course, are deductible under the head of rentals.

Rentals paid to stockholders of a corporation based upon net profits are held not to be dividends if payments were made for use of property and were not based on stockholdings.[55] Ostensible rental payments which are in reality distributions of profits to stockholders will not be allowed by the Treasury as business deductions.

Certain interest payments are held to be the equivalent of rentals and are deductible as such. (See Chapter XXXII.)

Taxes paid by a tenant.—

REGULATION. . . . . Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. . . . . (Art. 109.)

A statement in the 1918 *Primer* emphasizes the fact that in this case the property must not be used by the tenant as a home.[56]

Permanent improvements on leased ground.—

REGULATION. . . . . The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of lease, and such deduction shall be in lieu of a deduction for depreciation. If the remainder of the term of lease is greater than the probable life of the buildings erected, or of the improvements made, this deduction shall take the form of an allowance for depreciation.[57] . . . . (Art. 109.)

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[55] *In re General Film Corporation*, 274 Fed. 903.

[56] *Income Tax Primer*, 1918, question 69.

[57] [Former Procedure] In an early edition of Regulations 45, this part of this article read as follows:

"The lessee will not be permitted to deduct from the gross income any depreciation with respect to such buildings, but the cost of incidental repairs necessary to keep them in an efficient condition for the purposes

The Treasury has held, however, that a reserve to cover a possible but unknown cost of restoring the premises to their original condition is not deductible. The cost of restoring the property at the expiration of the lease, if the lessee is required to restore it, will be an allowable deduction for the year in which it is actually incurred.[58]

Rental of apartment deductible when subleased.—

RULING. The taxpayer lived in an apartment where it was the custom of the residents to sublease their apartments or houses for the summer months. In his 1920 return the taxpayer included in his gross income the amount received as rent for the apartment which he sublet and deducted as a business expense the amount which he had to pay as rent for the apartment, claiming that he had sublet his apartment as a purely business proposition and that the transaction was entered into for profit. He occupied no part of the apartment after it was sublet.

Held, that the rent which the taxpayer was required to pay for the apartment during the time that it was sublet at a profit is deductible in computing net income. (C. B. 5, page 122; O. D. 1134.)

Payments to co-operative apartment corporation.—

RULING. Each of the stockholders of a corporation owning certain apartment buildings is a proprietary lessee holding a lease for 99 years at $1 per year on an apartment or apartments of the value of the shares owned. Under the terms of the lease, each stockholder, in addition to the nominal rent of $1 per year, agrees to pay, when required by the board of directors, his proportionate share, based upon the number of shares of stock held by him, (1) of any deficiency arising from the operation and maintenance of the apartment building; (2) such sums as shall be necessary to enable the corporation to pay interest and to amortize mortgages; and (3) any and all necessary expenses incident to the ownership, maintenance, and operation of the property. The lease provides that so much of the payments received from the lessees as may be devoted to the payment of the principal of a mortgage or any other capital expenditures shall be credited upon the lessor's books to "paid-in surplus" account. The lessor's books clearly reflect the application of the payments to the reduction of mortgage indebtedness and other capital expenditures, and the stockholders are advised of the amounts so applied.

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of their use may be deducted. If, however, the life of the improvement is less than the life of the lease, depreciation may be taken by the lessee instead of treating the cost as rent."

[58] C. B. 2, page 112; O. D. 516.

Considering the specific provision of the proprietary lease for crediting payments made by the stockholders for the reduction of the mortgage indebtedness or for other capital expenditures to the "paid-in surplus" account in connection with the fact that the books of the corporation reflect the amount of the assessment payments used for such purposes and that the stockholders are advised of the respective amounts so applied, it is held that that portion of the assessment payments credited to the "paid-in surplus" account and devoted to the reduction of the corporation's mortgage indebtedness or for other capital purposes is in the nature of a voluntary assessment upon the stock held by the individual proprietary lessees, which, under article 544, Regulation 62, represents additional cost of such stock, and does not constitute income to the corporation. (I. T. 1302, Bulletin I-19, page 16, overruled in part.) (I-41-547; I. T. 1469.)

Deduction for payment for cancellation of lease.—Although the following case does not come under the principle upon which article 109 is based, it was decided in accordance therewith:

Ruling. A business property was leased for a term of years, but prior to the termination of the lease the lessor paid a fixed sum to the lessee for its cancellation.

Held, that the amount so paid by the lessor constitutes a business expense and that he may deduct an aliquot part thereof in his return for the year in which the lease was canceled and for each succeeding year the lease had to run. (C. B. 2, page 112; O. D. 397.)

The theory of the foregoing ruling would seem to be that the lessor made a capital investment in something he had disposed of, viz., the use of property which had been leased to another.

If the life of the lease does not extend beyond the taxable period, there is no doubt that the entire amount is deductible in the period.

Rulings. A lump sum paid as damages by the lessee of business premises, by reason of the cancellation of a lease for a term of years, is deductible for the year in which paid or accrued. (C. B. 5, page 129; Digest O. D. 974.)

The amount of a bonus paid by a corporation to secure immediate possession of a theatre under a lease which was limited to the taxable period, and attorneys' fees in connection with the transaction, constitute necessary expenses or costs of operation for such period and

are not required to be capitalized. (C. B. 3, page 129; Digest A. R. R. 178.)

A company purchased a building for its own occupancy, but at the time of the purchase a tenant was in possession, under a lease which had three years to run. In order to secure possession of the premises the company purchased the lease from the tenant.

Held, that the amount paid for the lease constituted a business expense to the company and that it should deduct an aliquot part thereof in its return for the year in which the lease was purchased and a similar amount in its return for each succeeding year during the life of the lease. (C. B. 3, page 265; O. D. 585.)

When March 1, 1913, value affects deduction for rent.—

RULING. The value as of March 1, 1913, of a leasehold acquired prior to that date, cannot be used in determining the amount deductible each year by the lessee when the leasehold was acquired on the basis of annual rental payments equal to a percentage of the income derived from the leased property, no specified sum having been paid in addition to the annual rentals. The amount deductible by the lessee each year is the rental payment. (C. B. 3, page 144; O. D. 675.)

The facts in the foregoing case are not stated and no intelligent criticism is possible, but comment is made because in many cases, similar on their face, lessees would be entitled to deductions in excess of the annual rental payment. If the rental were on a sliding scale it is probable that the lease would have had no capital value at March 1, 1913, but if the percentage were on a fixed basis, it is quite possible that the lease would have had a substantial value.

Department store buildings are frequently leased on the basis of annual rental payments equal to a percentage of the gross sales. If A leased a building to B for 20 years in 1903 on a basis of 2 per cent of sales and in 1913 the current rate was 7 per cent, B thereafter should deduct annually an amount in excess of the rental paid equal to a proportion of the capital value remaining on March 1, 1913. That is, if the value of the lease on March 1, 1913, was $100,000, B should deduct $10,000 annually for 10 years in addition to the rental payment.

Under T. D. 3414 the Treasury does not permit the de-

duction on this basis, but T. D. 3414 is questioned. For further discussion see Chapter XXXVI.

Cost of lease may be apportioned over term as rent.—

REGULATION. Where a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. . . . . (Art. 109.)

When a premium is paid to secure a lease, the amount represents an additional expense of doing business, the effect being the payment of a higher rent. The proper method of handling it is to set up the amount paid as a deferred asset, charging off each year the proportion of the premium which has expired. Since it represents increased rent, the rent paid and the proportion of the premium are in reality parts of one item.

A corporation issued $100,000 of its capital stock to pay for a leasehold having 31 years to run. The question arose as to how it should be treated in the accounts. If the value placed upon the leasehold was not excessive, the transaction was the same as if the corporation had sold its stock for cash and had then purchased the lease for cash. In that event it would have been proper to charge off each year as an expense one thirty-first of the amount paid.

RULING. In March, 1920, a taxpayer leased certain property, the lease to be effective October, 1922. To obtain the lease the lessee paid to the lessor *x* dollars to cover the period intervening between the date of the execution of the lease and date the lease becomes effective.

Held, that the sum paid in 1920 by the lessee for the privilege of securing this lease is a business expense and is a proper charge against the taxpayer's business for the period from March —, 1920, to October —, 1922, and is to be apportioned over that period. (C. B. 5, page 130; O. D. 1013.)

The payment for the period intervening is treated as an ordinary rental disbursement. Only the amount which applies to the taxable period may be taken as a deduction.

It is difficult to distinguish the foregoing ruling from the two following rulings.

RULINGS. B owned a lease which expired in 1921. A, in order to procure this lease at the expiration of B's term, agreed to pay to the lessor, in addition to a lump sum of $3x$ dollars for the lease for the period from 1921 to 1941, x dollars for each of the years 1917, 1918, 1919, and 1920.

Held, that the advanced payments were in effect a bonus and constituted a capital outlay representing additional cost of the leasehold acquired, and may not be construed as an ordinary or necessary expense of doing business for any year prior to the possession of the lease. (C. B. 5, page 128; Digest A. R. R. 676.)

The commission paid by the lessor to a broker for negotiating a long-term lease should not be prorated over the term of the lease but constitutes a proper deduction in computing net income for the year in which paid or accrued. (C. B. I-1, page 117; I. T. 1171.)

Deferred payments to lessor deductible when accrued.—

RULING. Under the terms of a lease of real estate it is provided that the lessee may withhold for the first three years of the life of the lease a certain part of the annual rental in order that it may conserve its liquid assets. The amounts so withheld are to be paid to the lessor in monthly installments during the remaining life of the lease. In the event of the cancellation of the lease the amounts so withheld are agreed to be an absolute liability of the lessee. The books of the lessee are kept on the accrual basis.

Held, that the amount of the rental withheld by the lessee during each of the first three years of the lease may be accrued as an expense for that year and deducted from gross income in its return. (C. B. 4, page 141; Digest O. D. 794.)

Rentals paid by professional men and others.—See "Business expenses of the professional man" (page 805).

Business Expenses Distinguished from Capital Outlay

Organization and similar expenses.—The Treasury has ruled that attorneys' fees, accountants' fees, fees paid to state authorities, and other expenditures usually grouped under the phrase "organization expenses," should be capitalized in some cases and in other cases may be deducted as current expenses.

REGULATION. Expenses of the organization of a corporation, such as incorporation fees, attorneys' and accountants' charges, are ordinarily capital expenditures, but where such expenditures are limited to purely incidental expenses, a taxpayer may charge such items against income in the year in which they are incurred. . . . . (Art. 582.)

The foregoing regulation, unlike the same article in Regulations 45,[59] accords at least in part, with the following, which may be taken as a fair reflection of present accounting practice:

Formerly if the expenses incurred in the organization of the company (such as incorporation fees, legal, engineering and other expenses, engraving bonds and stock certificates, transfer fees and stamps, etc.) were more than could fairly be charged into current expenses, it was considered permissible to spread such charges over a term of years, preferably three, but not more than five. Sentiment is changing as to the wisdom of spreading these expenses over more than three years. The best practice is to charge off immediately everything which has no tangible or residual value. The benefit from such items cannot be compared to advertising and exploitation expenses. It is a fallacy to assume that stock certificates, incorporation expenses, etc., have any of the attributes of an asset; and so the sooner the cost appears in the expense account, the better.

The old theory of deferring part of the charge to income was sound enough, but the rule has been abused; and so we now find apportionments over five years or longer. In some cases all organization expenses, using the term in its broadest sense, are permanently capitalized. The author advocates charging off all such expenses as they are incurred.[60]

If the expenses are actual and are incurred in good faith, they constitute deductions which should be allowable for the period during which they appear on the books as charges to expenses. If a corporation actually capitalizes the items, of course it must not claim credit for the deduction; but if it follows proper and now almost settled corporate practice, this class of expenditures should appear in its books as ordinary expenses. If state laws are complied with and the usual fees

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[59] **[Former Procedure]** For text and criticism of past practice, see *Income Tax Procedure*, 1921, pages 719-720.

[60] *Auditing, Theory and Practice*, Vol. 1 (3rd edition), R. H. Montgomery, page 576.

are charged and paid, certainly such expenses are necessary to the operation of the corporation. Furthermore, fees paid to the State, including stamps, are taxes and are therefore deductible under section 234 (a-3).

Expenses incurred in selling capital stock.—

REGULATIONS. . . . . If the stock is sold at a discount, the amount of the discount is not a loss deductible from gross income. . . . . (Art. 543.)

Any and all expenses incidental to or connected with the selling of the capital stock (common or preferred) of a corporation for the purpose of raising capital to be by it invested in property or employed in the business for which the corporation is organized are not an "expense of operation and maintenance" within the meaning of this title, and such expense is not an allowable deduction from the gross income, for the reason that such an expense is incurred in a capital transaction; that is, the raising of capital to be invested or employed in the business. . . . . (Reg. 33, 1918, Art. 145.)

The comments on organization expenses[61] apply to the foregoing regulation. Of course discounts on capital stock are not business expenses; but ordinary expenses of securing capital should not be capitalized. If it is not proper to capitalize an expense item, it should be an allowable deduction as a business expense.

REGULATION. . . . . A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stock holdings in the subsidiary may not deduct amounts paid in carrying out this guaranty in computing its net income, but such payments may be added to the cost of its stock in the subsidiary. . . . . (Art. 582.)

Assessments on stock.—The following ruling holds that voluntary assessments paid by security holders are not deductible by them as business expense:

REGULATION. . . . . Amounts to be assessed and paid under an agreement between bondholders or stockholders of a corporation, to be used in a reorganization of the corporation, are investments of

[61] See page 843.

capital and not deductible for any purpose in returns of income. . . . . An assessment paid by a stockholder of a national bank on account of his statutory liability is ordinarily not deductible. . . . . (Art. 293.)

Ruling. The payment of a statutory assessment under State law against a taxpayer as a stockholder of a bank is not a deductible loss in the year paid but is an additional capital expenditure which must be added to the original cost of his stock. Gain or loss can not be determined until the stock is sold or otherwise disposed of in a closed transaction. . . . . (C. B. 5, page 135; Digest A. R. R. 588.)

Expenses incurred in purchase of treasury stock—part of cost.—

Ruling. The expenses, exclusive of the purchase price, incurred by a company in purchasing its own stock for the purpose of retirement or holding as treasury stock, are not such expenses as can be classified as ordinary and necessary expenses incurred in carrying on the business, and hence are not deductible from gross income. These expenses are to be considered part of the purchase price of the stock retired. (C. B. 4, page 286; O. D. 852.)

Legal payments by corporations fall into three classes: (1) capital expenditures which have a continuing benefit, (2) payments to stockholders, (3) necessary expenses.

If the payments on account of stock returned to the treasury are made to stockholders, the above ruling is sound. If the expenses are ordinary and necessary, are not distributions to stockholders, nor expenses having a continuing benefit, they should be allowed as deductions.

Deferred charges—advertising, etc.—

Ruling. A corporation conducted in its taxable year a national campaign of advertising its manufactured product. Inquiry is made as to whether this expense of advertising must be charged off as an operating expense during the year in which it was incurred, or whether it can be carried as a deferred asset and charged off over a period of years.

It is held that the expenses of such advertising campaign are deductible as a business expense only in the return for the year in which such expenses were paid or in the year in which liability therefor accrued, if the books of the company are kept on an accrual basis. (C. B. 5, page 130; O. D. 1039.)

It has been the custom of some concerns to spread extraordinary expenditures over a period of years. If the future will assuredly receive some benefit therefrom, the policy is sound. (See "Organization and similar expenses, etc.," page 843.) But any doubt should always be settled in favor of an immediate absorption. If, however, these expenditures are in fact applicable to the business of several years, and are so treated on the taxpayer's books, the proportion actually charged to profit and loss for each taxable period is the only part which should be deducted in the income tax return.

Repairs and depreciation.—

REGULATION. The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve if such account is kept. . . . . (Art. 103.)

The tendency of some revenue agents is to question deductions for repairs on the theory that the usual depreciation allowances include ordinary maintenance.[62] The law permits deductions for maintenance and operation in addition to depreciation. The necessity for allowing both claims is very well expressed in a case[63] in which the court said:

DECISION. It will thus be seen that the deductions allowed are to include, not only ordinary and necessary amounts actually paid out in the operation of the property, but also the amounts paid out in the maintenance thereof, and in addition a reasonable sum for depreciation, if any. Now, the operation of a business or property includes payment for labor and materials which go into the actual operation thereof, while maintenance means the upkeep or preserving the condition of the property to be operated, and therefore, in my judgment, includes the cost of ordinary repairs necessary and proper from time to time for that purpose. "Depreciation," as used in the

[62] See Chapter XXXVI.
[63] *The San Francisco & Portland Steamship Co. v. Scott*, 253 Fed. 854. (T. D. 2773, November 8, 1918.)

statute is not to be confused with ordinary repairs. It is intended to cover the estimated lessening in value of the original property, if any, due to wear and tear, decay, or gradual decline from natural causes, inadequacy, obsolescence, etc., which at some time in the future will require the abandonment or replacement of the property, in spite of ordinary current repairs.

Equipment purchased on so-called rental plan.—In many cases equipment is purchased and title is reserved in the vendors until final payment is made. In the meantime the payments on account are treated as rental.

Technically, the payments may be looked upon as expenses because failure to pay the final instalment might result in the repossession of the equipment by the vendor, but in the case of solvent taxpayers the whole transaction is merely a purchase on the instalment plan. The entire purchase price should be set up as an asset on one side and as a deferred liability on the other. Depreciation should be written off as if the equipment were owned and the portion of each instalment which represents interest should be deducted from income.

If the rentals are charged as expenses it would be necessary to include the entire purchase price (less accrued depreciation) as taxable income for the year when title passes.

Cost of installing machinery not deductible.—

Ruling. The cost of installing machinery as well as the freight charges thereon are capital expenditures to be added to the cost of the machinery. . . . . (C. B. I-1, page 196; I. T. 1309.)

Cost connected with title to property not deductible.—

Regulation. . . . . The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense. . . . . (Art. 293.)

The cost of perfecting title is a proper capital charge, but the cost of defending title may not add anything to the value of the property. If not, the item is a business expense.

Ruling. The amount paid to contest the establishment by a municipality of a building line across the property of the taxpayer,

the establishment of which would threaten the continued unrestricted enjoyment of the property, is a capital expenditure and can not be deducted from income for the year in which paid or accrued. (I-27-390; Digest I. T. 1382.)

Expenses of obtaining return of property from Alien Property Custodian not deductible.—

Ruling. Attorneys' fees paid for services rendered in securing for a non-resident alien, the return of property and income from the Alien Property Custodian, are not allowable deductions from gross income. If the Alien Property Custodian returned property, as distinguished from money, the attorneys' fees should be treated as a part of the cost price of the property. If the Alien Property Custodian took over property, converted it into cash, and delivered money to the taxpayer, the attorneys' fees constitute an offset against the selling price. . . . . (C. B. 5, page 127; Digest O. D. 1048.)

It is unlikely that expenses incurred in connection with the recovery of seized property add to its value. If not, such expenses should be treated as business expenses.

Architect's fee not a business expense.—

Regulation. . . . . The amount expended for architect's services is part of the cost of the building. . . . . (Art. 293.)

Cost of copyright and plates not deductible.—

Regulation. . . . . Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. . . . . (Art. 293.)

In the two foregoing cases the payments are properly designated as capital, but it should be noted that the items become allowable deductions as depreciation when spread over a term of years.[64]

Expense of installing accounting system deductible.—

Ruling. Where, upon organization, a corporation took over the business of an individual and for six months continued the bookkeeping system used by its predecessor, the cost of revising and setting up a new system of accounting is not a capital expenditure. (I-28-404; Digest A. R. R. 992.)

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[64] See Chapter XXXVI.

Cost of drilling unproductive wells.—The Treasury has held that a taxpayer who drills unproductive wells in search for water on desert land cannot deduct the cost as it is not "regular, certain, or recurrent, sufficient to constitute it an ordinary and necessary expense," and must be treated as a capital investment. (I-44-570; I. T. 1486.) But the ruling concedes that the cost may be deducted as a loss "if and when realized." As the realization occurs when the results are known the ruling merely requires three book entries instead of one: the cost is debited to capital; capital is simultaneously credited and operating costs debited. And there you are!

Carrying charges on real estate.—A distinction must be drawn between operating expenses, which can be charged as necessary expenses of doing business, and expenses which arise when there is no going business which can be charged therewith.

Unproductive real estate is a case in point. There may be taxes, interest and other items of expense to be taken care of and no income out of which the payments can be made. Capital must be used to make the payments, and in the circumstances the items will be regarded as capital expenditures.[65] As soon as a property is being operated or used the capitalization of charges must cease, even though the property is being operated at a loss. If a property is only partly operated the charges may be partly capitalized.

Ruling. Where a corporation engaged in buying and selling real estate purchases a piece of property and holds it for a profit, the interest, taxes, and ordinary repairs incident to the property represent charges for the year in which paid or are so charged upon the books as to represent liabilities of the corporation and are allowable deductions in computing net income even though in excess of the gross income derived from the property. Such charges are not capital expenditures if the corporation has any income from which to deduct them and they should not be added to the cost of the property in determining the amount of gain or loss arising from its sale except to the extent that the corporation has no gross income

[65] C. B. 2, page 112; O. D. 398.

from any source against which to deduct such expenditures for the taxable year in which they were made. (C. B. 2, page 112; O. D. 398.)

The above ruling cannot be reconciled with the rulings given below which are said to express the present attitude of the Treasury. The author is of the opinion that if the taxes have not been deducted by the taxpayers in prior years, but are added to the cost of property for the purpose of computing profit or loss on sale, such a practice would be similar to the treatment of any capital expenditures. The law does not provide that taxes and interest *must* be deducted. The deductions are merely allowable. If these and other carrying charges are capitalized under a proper accounting system, they are not technical "deductions" in a subsequent year, but are part of the cost of the property and tend to reduce the gains or increase the losses arising from sales.

Rulings. Taxpayer bought lots in 1915 and sold them in 1920. During the years the property was in his possession he paid *x* dollars in taxes, which amount had not been deducted in returns of annual net income for the reason that he did not have sufficient income in any of those years to require the filing of a return.

Inquiry is made whether the taxes paid may be regarded as carrying charges and allowed as a deduction in the taxpayer's return for 1920.

Held, that the taxes paid in prior years may not be considered additional cost of the lots in determining the gain derived or loss sustained through their sale in 1920. Only such taxes as are paid or accrued within the taxable year can be deducted for the purpose of computing the net income of the taxpayer. (C. B. I-1, page 28; I. T. 1188.)

Inquiry is made whether I. T. 1188 (Bulletin I-6, page 8) overrules T. D. 2005.

The pertinent part of T. D. 2005 (not published in the Bulletin service) is as follows:

Cost of property purchased prior to the incidence of the special excise tax (January 1, 1909), or the incidence of the income tax (March 1, 1913), will be the actual price paid for the property, including the expense incident to the procurement of the property in the first instance and its sale thereafter, together with carrying charges of interest, insurance, and taxes actually paid prior to the incidence of tax (special assessments, if any, "actually paid" as "local benefits" in connection with real estate); provided that where, up to the in-

cidence of the tax, the expense of carrying property has exceeded the income from it, the difference between the expense of carrying and the income from the property shall be added to the purchase price and the sum thus ascertained shall be the cost of the property; and provided further, that in the case of property purchased prior to the incidence of the tax and sale thereof subsequent to the incidence of the tax there shall be excluded from consideration in ascertaining cost any items of income, expense, interest, and taxes previously taken into account in preparing a return of annual net income.

The ruling contained in I. T. 1188 expresses the present attitude of this office on the question of adding to the cost of property carrying charges, such as taxes, interest, etc., where the taxpayer had no income from which the tax can be deducted. Treasury Decision 2005 is not applicable to cases wherein taxes, interest, and similar carrying charges have been paid subsequent to the incidence of the special excise tax (January 1, 1909) or the incidence of the income tax (March 1, 1913). (C. B. I-1, page 30; I. T. 1338.)

When several properties are under one ownership, it is the custom to absorb the charges on the unproductive properties in the surplus income from productive property. There is no objection to this from a conservative accounting point of view. As long as capital gains were subject to high surtaxes, it was in many cases to the taxpayer's advantage to capitalize expenses on unproductive property, rather than to charge them off immediately, so as to minimize the amount to be reported as taxable profit in the year of sale. With the low rate of tax on capital gains, however, it will now be to the advantage of the taxpayer to have the profit on realization as large as possible and to get credit from year to year against income subject to high surtax rates for the carrying charges.

See further discussion on page 582.

Payments for goodwill not an expense.—In some cases payments are made which are in the nature of goodwill rather than expenses. Such payments should not be claimed as deductions even though it is decided that they should not be capitalized. Payments to a retiring partner, when in excess of reasonable compensation for services rendered, should be charged to goodwill and not to expenses.

Payments under leases or to officers of corporations in

excess of reasonable compensation for the use of property, or for services, are not ordinary or necessary expenses of a business.

Payments which properly are chargeable either to expenses or to capital, such as certain development and establishment expenditures, should not be charged on the books as expenses unless it is proposed to claim credit therefor as allowable deductions.

Miscellaneous

Lobbying expenses and campaign contributions not deductible.—

REGULATION. . . . . Sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses, are not deductible from gross income. (Art. 562.)

Lobbying expenses will probably appear under legal expenses and will no doubt be allowed. In the case of corporations, campaign contributions are illegal and should not appear in the books. The words "advertising other than trade advertising" were not used in Regulations 33 which were in force until 1919. Advertising Liberty bonds certainly is not trade advertising, but has been allowed. It would be held that any advertising for the good of a business would be an allowable deduction.

Trading stamps expenditure a business expense.—The Treasury in Regulations 45 and 62 has provided in a very definite manner for the deduction of trading stamp expense, in effect reversing the earlier ruling that a reserve set up as a liability equal to the redemption value of the stamps is not deductible.[66]

REGULATION. Where a taxpayer, for the purpose of promoting his business, issues with sales trading stamps or premium coupons

[66] [Former Procedure] A reserve set up was not deductible under an earlier regulation. (Reg. 33, 1918, Art. 141.)

redeemable in merchandise or cash, he should in computing the income from such sales subtract only the amount received or receivable which will be required for the redemption of such part of the total issue of trading stamps or premium coupons issued during the taxable year as will eventually be presented for redemption. This amount will be determined in the light of the experience of the taxpayer in his particular business and of other users engaged in similar businesses. The taxpayer shall file for each of the five preceding years, or such number of these years as stamps or coupons have been issued by him, a statement showing (*a*) the total issue of stamps during each year, (*b*) the total stamps redeemed in each year, and (*c*) the percentage for each year of the stamps redeemed to the stamps issued in such year. A similar statement shall also be presented showing the experience of other users of stamps or coupons whose experience is relied upon by the taxpayer to determine the amount to be subtracted from the proceeds of sales. The Commissioner will examine the basis used in each return, and in any case in which the amount subtracted in respect of such stamps or coupons is found to be excessive an amended return or amended returns will be required. (Art. 91.)

In effect the foregoing regulation permits the deducting of reserves set up for trading stamps.

Maintenance funds required by law should be deductible.—

Ruling. Payments to trustees by a cemetery corporation during the taxable year of a certain percentage of the proceeds of sales of cemetery lots set aside for a maintenance fund to be controlled solely by the trustees thereof are not deductible from the gross income of the corporation even though such payments are required by state law. (C. B. 2, page 216; O. D. 529.)

The author is of the opinion that the foregoing ruling is erroneous, and that it should be changed to accord with the principle laid down in article 567,[67] whereby banking corporations are allowed to deduct "depositors' guaranty funds" when such funds are required by law.

Dues paid to chambers of commerce and associations deductible.—

Ruling. Membership fees or dues paid by individuals and corporations to a chamber of commerce or board of trade are deductible from gross income as a business expense provided the membership

[67] See page 833.

is employed as a means of advancing the business interests of the individual or corporation. (C. B. 2, page 105; O. D. 421.)[68]

Likewise, fees paid to trade associations to promote the general business interests of members are also deductible.[69]

RULING. A corporation which is a member of different chambers of commerce or commercial clubs in different cities is called upon to make voluntary contributions to a budget fund in addition to regular dues, to be used for such purposes as the improvements of local streets, bringing conventions to the city, etc.

Held, that such contributions are not deductible as a business expense. (C. B. I-1, page 274; Digest I. T. 1153.)

The author is unable to reconcile the foregoing ruling with the intent of the law and with the previous decisions of the Treasury.

RULING. A certain civic federation, a corporation organized not for profit, supplies an information service in respect to matters of public taxation and conducts a general educational work with reference to pending matters affecting tax legislation and public expenditures.

Held, that contributions to it by its members do not represent a consideration for a direct benefit flowing to the donors and are not such ordinary and necessary expenses of the trade or business of such individual and corporation donors as are contemplated by section 214 (a) 1 and 234 (a) 1 and, therefore, are not proper deductions in the returns of such donors. . . . (C. B. I-1, page 118; Digest I. T. 1281.)

If the federation's services are of a general educational or scientific nature, the contributions by members are deductible because they are made to an exempt organization. If the services are of a business nature and some benefit flows to the individual contributors, the contributions are ordinary business expenses and are deductible.

Payments for baseball players.—

RULING. An amount paid by a baseball club to another baseball club as the purchase price of a contract between such club and a player covering the services of the player for a period of more than one

[68] See also I-33-456; A. R. R. 1052.
[69] C. B. 2, page 105; O. D. 496.

year is deductible from gross income during the life of the contract, a proportionate part of the price paid being deductible each year. (C. B. 4, page 142; O. D. 836.)

Dues paid to labor unions.—

Rulings. Dues paid by an individual to an organized labor union are deductible as a business expense in computing his net income for income-tax purposes. (C. B. 2, page 105; O. D. 450.)

Dues, deducted by a corporation from the salary or wages of its employees for membership in a benefit relief association, conducted by the corporation which pays sick, accident, and death benefits, and which the corporation compels the employees to join, are not deductible by the employees in computing net income. (C. B. I-1, page 193; Digest I. T. 1265.)

Fees paid to secure employment.—The following ruling is sound but it is not consistent with I. T. 1397,[70] which holds that expenses incurred in looking for work are not deductible.

Ruling. Fees paid to secure employment are considered allowable deductions for the purpose of computing net income subject to tax. (C. B. 3, page 130; O. D. 579.)

Initiation fee to stock exchange deductible.—

Ruling. The initiation fee paid to a stock exchange in order to secure a seat in the exchange, and which is not a part of the cost of the seat, is deductible as a business expense. (C. B. I-1, page 118; Digest I. T. 1271.)

Bonus paid for an early delivery of steamship.—

Ruling. A bonus was paid for the delivery of a steamship at a date earlier than that stipulated in the contract for its construction and the question is presented whether the amount is properly chargeable as a business expense or as a capital expenditure.

Held, that as the bonus paid for delivery at a date earlier than that contracted for added nothing to the value of the vessel after the contract date of delivery the amount so paid is properly chargeable as a business expense and is deductible from income received between the date of delivery of the vessel and the date it would have been delivered had no bonus been paid. (C. B. 3, page 131; O. D. 664.)

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[70] See page 811.

Earnings paid city, etc., by public utility an expense.—

REGULATION. . . . . In the case of a public utility acquired, constructed, operated, or maintained by a taxpayer under contract with any State, Territory, or political subdivision thereof, or with the District of Columbia, containing an agreement that a portion of the net earnings of such public utility shall be paid to the State, Territory, or political subdivision thereof, or the District of Columbia, the amount so paid may be deducted by the taxpayer as a necessary expense in transacting business. . . . . (Art. 87.)

Payments by railroads to Interstate Commerce Commission.—

RULING. Under the provisions of section 15—A of the Interstate Commerce Act, as amended by the Transportation Act approved February 29, 1920, railroad corporations are required to pay to the Interstate Commerce Commission one-half of their net railway operating income in excess of 6 per cent on their invested capital. It is understood that such payments are absolute, the railroad company having no present or future rights therein.

Held, that any sum so paid may be deducted in the taxable year in which paid or accrued, dependent upon whether the books of the corporation are kept upon a cash receipts and disbursements or accrual basis. (C. B. 5, page 219; O. D. 989.)

Expenses in connection with the breeding of horses deductible.—In a recent case,[71] it was held that the breeding of blooded horses was a business and that the expenses in connection therewith were therefore deductible.

Amounts paid on judgments or other binding adjudications.—

REGULATION. . . . . Judgments or other binding adjudication, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated[72] or paid, unless taken under other

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[71] *Wilson v. Eisner*, 282 Fed. 38.

[72] [Former Procedure]

RULING. A corporation was sued for infringing a trade-name covering a period ending in 1912. Judgment was obtained in 1916. The Treasury Department held that the amount of this judgment should be prorated over the period ending in 1912, according to the income of each year. Such part of it as by this method is found applicable

methods of accounting which clearly reflect the correct deductions, less any amount of such damages as may have been compensated for by insurance or otherwise. . . . . (Art. 111.)

The present regulations provide as a general rule that losses which occur in one year and which are not discovered until a later year cannot be deducted in the later year, but are only deductible as of the time when they actually occurred. However, in order to avoid injustice to the taxpayer and to reflect more clearly his income, the Commissioner may, in exceptional circumstances, permit a loss to be accounted for as of a year other than the one in which sustained.[73] The principle applies to all kinds of expenses, and exception is made only for overlapping items which do not materially disturb the income for any one year. The regulation has some merit and should be followed in most cases, but greater latitude should be given to taxpayers. If, in the opinion of the latter, true net income for the taxable year can be stated by charging items as an expense during the taxable year, taxpayers should not be forced to make amended returns for prior years. The inevitable result will be, if taxpayers are so forced, that for years to come they will be finding that expenses, which ordinarily would and should be charged to current operating accounts, occurred during the years 1918 and 1919 when the tax rates were very high, and acting under the letter of the

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to the income of the corporation for the period 1909 to 1912, would be referable to those years but no part of this sum would be deductible in the return of income for 1916.

The same corporation also paid in 1916 an additional sum as consideration for dismissal of a pending suit for interest on the above judgment from the date of the decision of the Circuit Court of Appeals to the date of payment and for the unrestrained use of the trade-name in question. The Treasury Department held that if this amount "can be segregated between *interest* and *use,* it would be treated the same as in the other case, for the period subsequent to 1912, and such part thereof as shall be thus found applicable to the 1916 income would be deductible in the return of income for that year under the respective heads of "business expense" and "interest," and if segregation has not been or cannot be made, the entire amount may be treated as "business expense" to be prorated as above indicated." (Substance of letter to The Corporation Trust Company, signed by Commissioner W. H. Osborn and dated February 9, 1917.)

[73] See Art. 146.

regulations, amended returns will be made with a resulting saving in tax.

The present regulations appear to modify the rule in cases when taxpayers have actually provided in prior periods for losses finally determined in later years. It is provided that judgments, etc., are deductible in the years when paid "unless otherwise provided for by the taxpayer's method of accounting." It is to be hoped that this refers to reserves which have been set up for accruing and estimated losses and liabilities set up in good faith in order to reflect true net income.

Deductions for probable but uncertain expenses.—

Ruling. The freight upon certain goods sold by the taxpayer is not prepaid but the price quoted to the customer includes an estimated amount for freight. The customer, upon receipt of the goods, pays the freight and is given credit by the taxpayer for the freight so paid. The taxpayer maintains a reserve for outgoing freight to care for this estimated freight on shipments, which reserve is not deductible from gross income. The freight is deductible when the account of the customer is credited. (C. B. I-1, page 132; Digest I. T. 1351.)

The foregoing ruling is not sound. The taxpayer contracts a liability for the freight. The so-called reserve is an entry which represents a definite liability. It is deductible under article 111 of the regulations.

Rulings. A report of a master in chancery, appointed by an interlocutory decree in a suit for damages for alleged infringement of a patent, assessing damages against the taxpayer, which report was filed during the taxable year, but was not confirmed until the following year when judgment was entered on the report, can not be regarded as a determination of the amount of the claim, and no deduction for the taxable year is permissible in regard to the judgment referred to. . . . . (C. B. 1, page 108; Digest S. 923.)

A reserve to cover a contingent liability, representing an estimated amount of claims actually outstanding at the close of the year, which will be paid on account of loss and damage to freight and injuries to persons, is not deductible. Such amounts are deductible only for the year when the claims are put in judgment or paid. (C. B. 4, page 142; Digest O. D. 879.)

In 1918 the M corporation entered into contracts for the installation of certain machinery. In connection with such contracts a "con-

tingent fund" account was set up on the corporation's books in 1919 and 1920 for the payment of unforeseen expenses and bonuses to be paid after the completion of the work and the payment of all liabilities under the contracts, the respective amounts of the bonuses to be determined after taking into consideration the services rendered and the loyalty displayed by the employees.

Held, that the bonuses are deductible only in the year 1922, when they were authorized to be paid. (C. B. I-1, page 131; Digest I. T. 1350.)

The question involved in the foregoing rulings is a difficult one to discuss. If it appears that an expense has been incurred but its amount is doubtful, good accounting practice and conservative business methods demand that an estimate be made and entered in the books. It would be a dangerous practice to omit a liability from the books merely because the *exact* amount thereof was unknown. The law permits the deduction of necessary business expenses and expressly approves the accrual system of accounting. It is therefore safe to assume that when during a taxable year an expense has been incurred or when it is so probable that an expense has been incurred that good practice requires the setting up of the transaction as a liability, the amount of the expense (even though it is an estimate) when entered in the books in good faith will be held by the courts to be deductible in the same period. The controlling idea is that the income of a future period should never have to bear expenses which belong to a past period. The law need not be amended to effect this. The author has no serious criticism to make of the practice of requiring amended returns so long as the Treasury is consistent, but *in no case* should substantial expenses and losses applicable to a past period be carried forward to a subsequent period when the taxpayer has made provision for such expenses in the period to which the expenses are chargeable.

Payments to trustee for the ultimate benefit of the taxpayer not deductible.—

Ruling. Pursuant to the requirements of its by-laws a corporation entered into a trust agreement under the terms of which a sum

amounting to not less than a certain per cent of the corporation's paid-in capital stock must be turned over to the trustee annually until a fund has accumulated amounting to x dollars, inclusive of the interest which is required to be added to the principal, when the income therefrom is to be turned over annually to an executive committee of the corporation for a purpose related to the business of the corporation.

Held, that the amounts paid to the trustee by the corporation are not deductible from its gross income.

The interest accruing to the fund is income of the corporation which should be reported by it in its return. . . . . (C. B. 5, page 120; Digest O. D. 1047.)

Attorney's fees, when deductible.—Attorney's fees paid by a proprietor of a retail business, who was fined and imprisoned for making illegal sales, have been held to be personal.[74]

The Treasury holds in effect that *gross* income earned illegally is taxable. The theory may be commendable but it is doubtful if the ruling is sound. If it is, many other deductions arising from illegal transactions would not be deductible.

When the attorney's fees were paid in connection with litigation regarding the control of certain stock, it was held that the fees were not deductible.[75]

Legal and traveling expenses were held not deductible when expended in contesting an additional assessment.[76]

The Treasury's position may or may not be sound. It is at least questionable. The services of attorneys may be for personal or for business purposes. If it can be shown that the transactions are ordinary business transactions, all incidental expenses are fully deductible, the Treasury to the contrary notwithstanding. The necessary legal expenses of a business man who is charged with the infraction of a business law cannot be deemed to be personal. All of the income from the business is taxable even though the business is more successful than it really ought to be. Likewise, all expenses

[74] C. B. 4, page 209; O. D. 952.
[75] *Laemmle v. Eisner,* 275 Fed. 504.
[76] C. B. I-1, page 196; I. T. 1319.

are deductible even though the business is not conducted as government officers would conduct it. The latter may be wrong. Business men should carry to the courts many of the disallowances discussed in this chapter. The author believes that the courts will confirm the deduction of every expense which is incurred in good faith.

It has also been held that a fine paid by a corporation for violation of the Anti-Trust Act is not deductible as an ordinary and necessary expense.[77]

Expenses of abandoned project.—A taxpayer who sent an agent to Europe to organize an export business deducted the expenses. The report was unfavorable and the idea was abandoned. Held that it was not an expense of the taxpayer's business because "his income consisted entirely of salaries and interest." But as it was a transaction entered into for profit the expenditure "became a loss which was deductible." (I-47-603; I. T. 1505.)

For a distinction without a difference the foregoing takes first prize.

[77] C. B. I-1, page 269; I. T. 1174.

CHAPTER XXXII

DEDUCTIONS FOR INTEREST

Prior to 1918, income tax procedure, so far as it related to corporations, was complicated by restrictions upon deductions for interest paid, which made it necessary to distinguish interest payments by corporations very sharply from other payments.[1] With the disappearance of this restriction the procedure has become relatively simple.

Deductions allowed to individuals.—

LAW. Section 214. (a) . . . . (2) **All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;**[2] . . . .

Deductions allowed to corporations.—

LAW. Section 234. (a) . . . . (2) **All interest paid or accrued**

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[1] **[Former Procedure]** The arbitrary restriction imposed by the 1913, 1916 and 1917 laws and its effect is fully discussed in *Income Tax Procedure,* 1919, pages 454-463. In May, 1922, the Treasury published a ruling, reversing former procedure, distinguishing between "discounts" and "interest" and holding that the former do not fall within the limitations of the 1916 and 1917 laws.

RULING. Discount on notes received from customers should not be treated as interest limited to an amount allowable under article 180, Regulations 33, revised. The face of the note having been reported in gross income, the discount paid thereon should be allowed as an expense of doing business instead of treating the same as interest. (C. B. I-1, page 246; A. R. R. 880.)

[2] **[Former Procedure]**

1917 LAW. Section 5. "(a) . . . . Second. All interest paid within the year on his indebtedness except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation as income under this title; . . . . "

This restriction was introduced by the 1917 law. Before that time an interest deduction was not disallowed because incurred for the purchase of tax-exempt securities. The 1918 law introduced the words "or carry" in speaking of tax-exempt securities.

within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title; . . . .

REGULATION. Interest paid or accrued within the year on indebtedness may be deducted from gross income, except that interest on indebtedness incurred or continued to purchase or carry securities, such as municipal bonds and first Liberty loan 3½ per cent bonds, the interest upon which is wholly exempt from tax, is not deductible. This exception, however, does not apply in the case of 3¾ per cent Victory notes originally subscribed for by the taxpayer, and interest on indebtedness incurred to purchase or carry such notes is deductible. Since other obligations of the United States issued after September 24, 1917, are not wholly exempt from taxation under this title, interest paid on indebtedness incurred or continued to purchase such obligations (whether or not originally subscribed for by the taxpayer) is deductible in accordance with the general rule. . . . (Art. 121.)

Interest which is deductible.—All interest paid on indebtedness by an individual or a corporation is deductible, except interest paid on money borrowed to purchase or carry certain securities the interest upon which is wholly exempt from taxation.

United States obligations issued prior to September 24, 1917, including first or 3½ per cent Liberty bonds, are exempt from taxation and interest on money borrowed to purchase or carry such obligations is not deductible. This date, September 24, 1917, marked a change of policy by the United States government. The understanding was that after that date securities entirely exempt from taxation were not to be issued, and, consequently, the restriction on the deduction for interest was not applied to interest paid on money borrowed to carry obligations of the United States issued thereafter.[3]

[3] [Former Procedure] The 1917 law did not allow as a deduction interest paid on indebtedness incurred for the purchase of obligations of the United States issued after September 24, 1917, to the extent to which any part of the interest from such obligations was tax-exempt. The law entirely omitted the reference to obligations of the United States, and it was therefore held that any interest paid on

Nevertheless, in the eagerness to make the offering attractive, 3¾ per cent Victory notes were issued in 1919 entirely free from taxation. The sections of the law quoted above provide that interest on money borrowed to purchase or carry the 3¾ per cent notes is deductible in income tax returns only when the notes are in hands of original purchasers, a restriction introduced in 1921.

In disallowing the deduction of interest paid to carry Victory notes other than original subscriptions, the Treasury cannot be accused of a breach of faith because the representations made were only in connection with the original subscriptions to the various issues after the first. The mere fact that other than original subscribers were given the same advantage under the 1918 law was really a gift by Congress, which it was quite at liberty to withdraw at any time on reasonable notice.

Interest on loan to cover loss on liberty bonds.—

Ruling. The interest paid on a loan which a taxpayer was obliged to continue in order to cover losses sustained on the sale of Liberty bonds is an allowable deduction from gross income under the provisions of section 234 (a) 2 of the Revenue Act of 1921. Likewise, interest paid on a loan made to pay city taxes, Liberty bonds being deposited as security for the loan, is deductible for income-tax purposes. (C. B. I-1, page 132; I. T. 1213.)

Interest on scrip dividends deductible.—

Regulation. Interest paid by a corporation on scrip dividends is an allowable deduction. . . . .

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indebtedness in respect of the $5,000 of second Liberty bonds (the interest on which principal amount of bonds was exempt) was not deductible. This restriction was made effective by the following directions in section E, page 2 of income tax form 1040 (revised January, 1918):

Interest on bonds and other obligations of the United States issued since September 1, 1917.—

Interest paid. "If indebtedness has been incurred for the purchase of such obligations, find what percentage the amount of such obligations held in excess of $5,000 is of the total amount of such obligations held, and enter in column 5 the same percentage of the interest paid on the indebtedness."

INTEREST ON CERTIFICATES OF DEPOSIT DEDUCTIBLE.—

. . . . In the case of banks and loan or trust companies, interest paid within the year on deposits or on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank or loan or trust company may be deducted from gross income. (Art. 564.)

INTEREST ON REAL ESTATE MORTGAGE DEDUCTIBLE.—

REGULATION. . . . . Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. . . . . (Art. 121.)[4]

SHOULD DISCOUNT ON BONDS BE TREATED AS PAYMENT OF INTEREST?—Bonds usually sell at a discount because the interest is fixed at a lower rate than the purchasers of the bonds think the debtor corporation should pay. Under proper accounting methods the discount is distributed ratably over the life of the bonds. The annual interest paid plus the annual proportion of discount forms the true interest.

REGULATION. . . . . If it [a corporation] sells its bonds at a discount, the amount of such discount is treated in the same way as interest paid, ... (Art. 563.)

The Treasury in the past treated the discount as a loss;[5] therefore the discussion of bond discounts as a deduction will be found in Chapter XXXIV.

BANKS OF DEPOSIT MAY DEDUCT INTEREST PAID ON DEPOSITS, EVEN THOUGH MOST OF THE ASSETS CONSIST OF TAX-EXEMPT BONDS.—An interesting question arose in the case of a bank which paid interest on deposits and invested most of its assets in tax-exempt bonds.

The interest from tax-exempt bonds not being returnable, and the interest paid to depositors and the expenses being great enough to offset the income from other sources than the tax-exempt bonds, the bank was not subject to tax.

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[4] As to the deductibility of carrying charges in general, see pages 582 and 850 *et seq.*

[5] Reg. 33, Art. 135.

RULING. It is the ruling of this office that a bank doing a commercial business and receiving deposits upon which it pays interest is entitled to deduct from its gross income shown upon its annual tax return the full amount of interest paid to its depositors. The payment of such interest is one of the ordinary and necessary expenses in the carrying on of its banking business. Although the deposits constitute indebtedness of the bank, such indebtedness was not incurred and is not continued for the purpose of purchasing or carrying obligations, even though the deposits are invested in bonds or other obligations the interest upon which is wholly exempt from income and excess profits tax. (Letter to Lybrand, Ross Bros. & Montgomery, signed by Commissioner Roper, June 24, 1919.)

INTEREST ON OVERDUE FEDERAL TAXES IS DEDUCTIBLE.—Many taxpayers, when additional or delinquent taxes are paid, treat the entire payments as tax payments. Since federal income and profits taxes are not allowable deductions but interest is fully deductible, it is important to separate the payment of interest, if any be included in tax payments.

RULINGS. Interest paid or accrued under the provisions of section 250 (a), (b) and (c), Revenue Act of 1918 is deductible under the provisions of section 214 (a) 2 or section 234 (a) 2 in computing net income. . . . . (C. B. 2, page 227; Digest O. 922.)

Interest paid to the United States Government on overdue Federal estate tax constitutes an allowable deduction from the gross income of an estate in process of administration for the year in which paid. (O. D. 594, C. B. 3, page 148, overruled.) (C. B. I-1, page 132; I. T. 1317.)

STATE TAXES DEDUCTIBLE AS INTEREST—WHEN?—Notwithstanding the phrase "or any other tax paid pursuant to the contract"[6] a very liberal regulation has been issued stating that a corporation paying a state tax or any other than a federal tax for someone else pursuant to its agreement may deduct such payment as interest paid on indebtedness. This regulation is as follows:

REGULATION. Corporations may deduct taxes from gross income to the same extent as individuals, except that in the case of corporate bonds or obligations containing a tax-free covenant clause, the cor-

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[6] Section 234 (a-3).

poration paying a Federal tax,[7] or any part of it, for some one else pursuant to its agreement is not entitled to deduct such payment from gross income on any ground. In the case, however, of corporate bonds or obligations containing an appropriate tax-free covenant clause, the corporation paying a State tax or any other than a Federal tax for some one else pursuant to its agreement may deduct such payment as interest paid on indebtedness.[8] (Art. 565.)

Bank charges on tax-exempt obligations may be deducted.—

Ruling. . . . . Interest paid by a contractor on funds advanced by a bank and discount charged by the bank for cashing municipal certificates of indebtedness are deductible from gross income. . . . . (C. B. 5, page 102; Digest O. D. 999.)

Interest on dividends paid by court order deductible.—

Ruling. Where a court of original jurisdiction entered a decree in 1917 requiring a corporation to distribute dividends, and upon an appeal the decree was affirmed by a court of last resort, which in addition to confirming the decree of the lower court awarded interest on the amount of the dividends from the date of the decree of the lower court to the date of payment, such interest is deductible from the gross income of the corporation for the year in which paid, ... (C. B. 4, page 141; Digest O. D. 778.)

Interest on construction is deductible if not capitalized.—

Ruling. Interest and taxes paid by a corporation in connection with the construction of its original plant are deductible from its gross income under the Revenue Act of 1913, even though such payments are properly chargeable to capital account and are so charged by the corporation on its books, provided the corporation amends its returns so as to exclude the interest and taxes so deducted from capital account. . . . . (C. B. 1, page 109; Digest S. 935.)

Payment under guaranty of interest.—

Ruling. Payment under guaranty of interest of an insolvent principal is a legal deduction from the gross income of the corpora-

[7] [Former Procedure] In the earlier edition of Regulations 45 in place of the phrase "paying a federal tax" there appears this expression "paying a tax . . . . whether federal, state or otherwise." The regulation was inaccurate as state taxes are and always have been deductible.

[8] Federal income tax paid by the obligor under a tax-free covenant clause is not to be included in the gross income of the obligee. See page 675.

tion making the payment, either as an operating expense or as interest, or as a bad debt, provided it is charged off the books of account of the guarantor. . . . . (C. B. 2, page 113; Digest S. 1298.)

Accrued interest on decedent's notes deductible by administrator.—

Ruling. Accrued interest upon outstanding notes of a decedent, paid by his administrator, which was deducted from the decedent's estate for estate tax purposes, is an allowable deduction from income in the return of the administrator.

Where the interest upon a note is capitalized by giving a new note representing the aggregate of the old note with interest accrued, only the amount of accrued interest paid upon the new note can be deducted, the new notes representing payment of both principal and interest of the old. . . . . (C. B. 2, page 114; Digest A. R. R. 113.)

Interest which is not deductible.—Generally speaking, the only interest on borrowed money which is not deductible is that paid on indebtedness created or continued to purchase or carry state and municipal bonds, United States bonds issued prior to September 24, 1917 (including Liberty 3½'s), Farm Loan bonds, and United States Victory 3¾'s not originally subscribed for.

Interest limitation is sound.—The restriction on the deduction is sound. It was made imperative by the establishment of very high income tax rates. So long as the rates of the tax were low, there was no appreciable inducement to a taxpayer to borrow money with which to buy tax-exempt securities. Under very high surtax rates the situation changed. Without this restriction, taxpayers subject to high rates would find it profitable to buy tax-exempt securities on a large scale with borrowed money, using the interest on such borrowings as a deduction from taxable income from other sources.

Segregation of interest paid when both exempt and non-exempt securities are used as collateral.—It is assumed that a borrower would use tax-exempt securities as collateral only when no other collateral is available. This

will insure the greatest saving in taxes and the least annoyance in bookkeeping.

When the collateral consists of both exempt and non-exempt classes, as above defined, part of the interest paid is deductible and part is not deductible.

There are at least three methods in use for determining the amount of deductible interest, two of which are not entirely accurate:

1. By calculating as deductible the same proportion of the total interest paid as the taxable interest received on bonds pledged is of the whole amount of interest received on pledged bonds;
2. By averaging by the month the relative amounts of principal of taxable and non-taxable bonds pledged and applying the result for the year to the interest paid; and
3. By apportioning between exempt and non-exempt securities the interest paid, in the ratio that the market value of one class of securities bears to the other.

The third is the only accurate method, since collateral loans are made by lenders on the market value of the securities pledged, and not on their par value or income-producing basis.

Law. Section 234. (a) . . . . (3) . . . . (c) . . . . In the case of obligors specified in subdivision (b) of section 221 no deduction for the payment of the tax imposed by this title, or any other tax paid pursuant to the contract . . . . shall be allowed. . . . .

Federal taxes assumed by corporation issuing tax-free bonds not deductible as interest.—When collection at the source was provided for in the 1913 law it was found that many corporations had made contracts with their bondholders under the terms of which the corporations agreed to pay for the bondholders any taxes they might be required to retain out of interest due the bondholder. These contracts were supposed to influence favorably the terms upon which bonds could be sold. Under such a theory the subsequent imposition of a tax which falls within the contractual obligation means to the corpora-

tions additional cost of money borrowed—hence the equivalent of an increased interest rate. As a necessary expense of doing business, taxes paid on this account should be an allowable deduction, but on the ground that the payments constitute the voluntary assumption of taxes assessed against bondholders and not the corporations the law does not permit the latter to deduct the payments in their tax returns either as interest or taxes.[9] The Treasury holds that only the federal taxes paid under such contracts are non-deductible (Art. 565, see page 910).

Certain ground rents not deductible as interest.—

Regulation. . . . . Payments made for Maryland or Pennsylvania ground rents are not deductible as interest but may, under proper circumstances, be deducted as rent. (Art. 121.)

Ground rent is defined to be a rent reserved by the grantor of land to himself and his heirs out of the land itself. It is not granted like an annuity or a rent charge, but is reserved out of the conveyance of the land in fee. It is an estate separate from the ownership of the ground, and is held to be real estate, with the usual characteristics of an estate in fee simple—descendible, devisable and alienable.[10]

A rental for other than business purposes is not an allowable deduction under the income tax, while no such restriction applies in the case of interest payments. The refusal to permit ground rents such as those described to be deducted as interest is to prevent rents of non-business character from being deducted under the guise of interest payments.

Dividends on preferred stock not deductible as interest.—

Regulation. . . . . So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in arriving at net income. . . . .[11] (Art. 564.)

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[9] Under the 1921 law the obligees do not have to include such taxes in their gross income as additional interest. Prior laws did not contain such a requirement but the Treasury established it by regulation.

[10] *Wilson v. Iseminger*, 185 U. S. 55, 46 L. Ed. 804, 22 Sup. Ct. 573.

[11] See page 702 *et seq.*

Interest paid on instalment subscriptions to capital stock not deductible.—When interest was paid on the instalments due under a contract to subscribe for stock, such interest is considered as a distribution of profits to the stockholders and as such is not deductible by the corporation.[12]

If interest is paid ratably to all stockholders it might be deemed to be a distribution of profits; but if paid to some on the theory of borrowed money and not to others, the interest payments should be treated as fully allowable.

Interest on taxpayer's own capital[13] not deductible.—

Regulation. Interest calculated for cost-keeping or other purposes on account of capital or surplus invested in the business but which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. (Art. 122.)

The author considers this position to be entirely sound.[14] If the concern did deduct such interest, it should logically account for it immediately as interest received. The point is covered more fully in an earlier Treasury decision, quoted in part below.

Ruling. A corporation would not be permitted to include in its deductions the rental value of the property which it owns and occupies nor would it be permitted to deduct from gross income the interest which the capital invested or employed would earn were it otherwise invested.

It therefore follows that a corporation cannot take into account as a part of the cost of manufacture any possible earnings; that is, earnings which might accrue on its capital or investment had such capital been so placed as to earn a given rate of interest. (T. D. 2137, January 30, 1915.)

Payments under certain annuity contracts.—A taxpayer (A) in consideration of the receipt of $120x$ dollars agreed

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[12] C. B. 5, page 284; O. D. 991.

[13] The economic term for so-called interest charged against oneself as a cost or carrying charge is "imputed" interest.

[14] *Auditing, Theory and Practice* (3rd edition), Vol. I, by R. H. Montgomery, page 155 *et seq.*

to pay to B $12x$ dollars per annum for life, and executed a mortgage in favor of B as security. A deducted the $12x$ payments "as a deduction on account of interest paid." The Treasury held that the payments "constitute annuity payments" and that A is not entitled to any deduction unless and until his total payments exceed $120x$ dollars. (I-44-568; I. T. 1484.) See also C. B. I-1, page 61; I. T. 1242.

Accounting procedure.—

Accrual basis is permitted.—Sections 214 and 234 of the law specifically state that "all interest *paid or accrued within* the taxable year on indebtedness" shall be allowed as a deduction. From the point of view of the government and the taxpayer alike it is desirable that the interest deduction should be based upon the books of the taxpayer, provided always, of course, that the books are kept properly and honestly. Every well-kept set of books reflects the interest accrued during the year. Interest payments may and do fluctuate. Large loans may fall due on January 1 and have interest paid on December 31 in one year and on January 2 in another year. Although there may be some gain or loss in taxes in the year when a change is made from one basis to the other, the net difference between the accrual and the paid basis is nothing at all over a period of years, unless the tax rate changes.[15]

[15] [Former Procedure] The 1913 law permitted individuals to deduct "interest paid within the year" (section II, B) and allowed corporations to deduct interest "accrued and paid within the year" [section II, G (b) (third)]. In its interpretation the Treasury held, in the case of corporations, that to be allowable as a deduction, interest must be both accrued and paid within the same year (T. D. 1916). The 1916 law used the phrase "paid within the year" in describing the interest deductions of both individuals and corporations [section 5 (a) (second); section 12 (a) (third)]. The same law permitted the use of the accrual basis by corporations [section 13 (d)]. The ruling issued to cover this point was T. D. 2433 (January 8, 1917).

Prior to January 8, 1917, the government insisted that the interest allowance be reported on the paid basis. After that date in the case of

When accrued interest is not deductible.—

Ruling. A lumber company entered into a contract for the purchase of a timber tract, agreeing to pay for the quantity of timber which it is estimated will be cut each year, payment to be made at the time each block is cut at a certain rate per thousand feet, plus interest at 6 per cent per annum from the date of contract.

Held, that inasmuch as the interest charge did not accrue and become payable until the timber was cut, it was not a proper deduction until that time. The agreement is an executory contract to purchase the timber and no interest is deductible except as the contract is executed. The interest payment does not constitute an operating expense of the company, but enters into the cost of the lumber produced that year. (C. B. 3, page 149; O. D. 595.)

Interest paid to partners.—From an accounting point of view interest paid to partners upon contributed capital or so-called partnership loans is an expense of the business only so far as the partners themselves are concerned. Contributions by general partners are at the risk of the business so far as creditors are concerned, and it is customary in preparing balance sheets to combine all the partners' accounts as the aggregate capital of the partnership, irrespective of how the balances appear upon the firm's books. Under income tax procedure it is of no importance to the government whether interest is allowed or paid to partners. If charged on one side of the returns as an expense, the same amounts appear on the other side as income and the tax to be paid is not affected.[16]

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individuals the regulations contented themselves with a general permission to make a return on a basis other than that of actual receipts and disbursements if the basis clearly reflected the income. (Reg. 33, 1918, Art. 24.) In the case of corporations, on the other hand, the utilization of the accrual basis for interest deductions was specifically authorized. (Reg. 33, 1918 Art. 180.)

[16] [Former Procedure] Under the excess profits tax law of 1917 which required a statement of invested capital and a determination of partnership profits as distinguished from the individual's net income, it made a decided difference whether or not interest on partners' loans or capital accounts were entered as a business expense. See *Income Tax Procedure,* 1922, page 935, footnote.

Individual interest deduction too broad.—Congress may be criticized because the interest deduction permitted to individuals is too generous. The law is supposed to proceed on the theory that the specific exemptions are sufficient to cover minimum personal living expenses—to provide the necessary creature comforts. Living expenses above this minimum are not supposed to be deductible. But if a man borrows money to buy an automobile, or places a mortgage on his house because he is living beyond his means, he is permitted under the law to deduct all such interest paid. It is clearly a living expense and theoretically should not be deductible. It would seem equitable that the law should permit the deduction of interest payments only where the interest-bearing debt was incurred in the purchase of property or investments for income-producing purposes. Such a provision raises some practical difficulties, such as that of designating the particular purposes for which the proceeds of a loan are used, but they are not insurmountable.

CHAPTER XXXIII

DEDUCTIONS FOR TAXES

The 1918 law was generous in its treatment of taxpayers, so far as allowances for taxes paid were concerned. The changes which were made by the 1921 law, while operating in the main to reduce the benefit that may be claimed by taxpayers, are still of so reasonable a nature that no great objections can be raised against them.

All taxes paid in this country, except federal income tax and certain types of special assessments, are still allowable in determining the amount of income tax payable, either as deductions from the amount upon which the income tax is to be calculated, or else as a credit against the amount of taxes payable.

One important change was introduced in the 1921 law which affects both corporations and individuals receiving income from abroad. The foreign tax allowed as a credit in such cases cannot exceed the same average rate on the foreign income which the United States income and profits taxes are on the total income from both foreign and domestic sources; or, as the law puts it, that the credit taken shall not exceed the same proportion of tax against which credit is taken, which the foreign income of the taxpayer bears to his entire net income.

Inheritance taxes are permitted as a deduction from gross income under the 1921 law.

Prior to 1921, subjects of a foreign country resident in the United States could deduct the amount of "any such taxes paid during the taxable year to *such country*" if certain reciprocal advantages were granted to American citizens residing in that country. The 1921 law changes this to

"the amount of any such taxes paid during the taxable year to *any foreign country* if the foreign country of which such alien resident is a citizen or subject . . . . allows a similar credit to citizens of the United States . . . ." [sec. 222 (a-3)].

The result of this change is that the citizen of Canada, for example, who formerly could obtain credit only for Canadian taxes, may now obtain credit for taxes paid to countries such as Great Britain or France, which have no reciprocal clauses in their tax laws. This means that the credit depends entirely upon the attitude of the government of which the resident alien is a national.

Taxes Deductible

Individuals.—

LAW. Section 214. (a) That in computing net income there shall be allowed as deductions: . . . .

(3) Taxes paid or accrued within the taxable year except (a) income, war-profits, and excess-profits taxes imposed by the authority of the United States, (b) so much of the income, war-profits and excess-profits taxes, imposed by the authority of any foreign country or possession of the United States, as is allowed as a credit under section 222, (c) taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and (d) taxes imposed upon the taxpayer upon his interest as shareholder or member of a corporation, which are paid by the corporation without reimbursement from the taxpayer. For the purpose of this paragraph estate, inheritance, legacy, and succession taxes accrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes; . . . .

Corporations.—

LAW. Section 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: . . . .

(3) Taxes paid or accrued within the taxable year except (a) income, war-profits, and excess-profits taxes imposed by the authority of the United States, (b) so much of the income, war-profits and excess-profits taxes imposed by the authority of any foreign country or possession of the United States as is allowed as a credit under section 238, and (c) taxes assessed against local benefits of a kind

tending to increase the value of the property assessed. In the case of obligors specified in subdivision (b) of section 221 no deduction for the payment of the tax imposed by this title, or any other tax paid pursuant to the contract or provision referred to in that subdivision, shall be allowed nor shall such tax be included in the gross income of the obligee. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed upon a shareholder or member of a corporation upon his interest as shareholder or member, which are paid by the corporation without reimbursement from the shareholder or member, but in such cases no deduction shall be allowed the shareholder or member for the amount of such taxes. For the purpose of this paragraph, estate, inheritance, legacy, and succession taxes accrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes;[1]. . . .

The foregoing section provides a blanket deduction for *all taxes except*:

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[1] [Former Procedure] The provisions of the 1913 law relating to individuals read simply "all national, state, county, school and municipal taxes paid within the year, not including those assessed against local benefits." (Section II, B, third.) The corporation section of the 1913 law was as follows: "All sums paid by it (the corporation) within the year for taxes imposed under the authority of the United States or of any State or Territory thereof, or imposed by the government of any foreign country." [Section II, G (b), fourth.]

Under the law of 1913 taxes paid to a foreign country by citizens or alien residents of the United States were not allowable deductions. The provisions of the law for the deduction of taxes applied only to taxes paid to the United States, or to some state or political subdivision thereof in the United States. It was evidently an oversight on the part of the framers of the law. In his report of December 6, 1915, the Commissioner of Internal Revenue recommended that foreign taxes be made allowable deductions, which was done in the 1916 law. In considering returns prior to 1916, this change in the law must be kept in mind.

1916 LAW (as amended in 1917). Section 5. "That in computing net income in the case of a citizen or resident of the United States—

"(a) For the purpose of the tax there shall be allowed as deductions— . . . .

"Third. Taxes paid within the year imposed by the authority of the United States (except income and excess profits taxes) or of its Territories, or possessions, or any foreign country, or by the authority of any State, county, school district, or municipality, or other taxing subdivision of any State, not including those assessed against local benefits."

The phrase "except income and excess profits taxes" was inserted in the 1917 law. The provisions of the 1917 law relating to deductions for taxes paid were exactly the same for individuals and for corporations.

1. United States income, war profits and excess profits taxes.
2. A proportionate part of income, war profits and excess profits taxes imposed by a foreign country or possession of the United States. [See section 222 (a-5).]
3. Local improvement taxes.
4. Taxes paid pursuant to a tax-free covenant in corporate obligations. (But such tax may be credited against the total tax payable by the obligee.)
5. Taxes on stockholdings, paid by the corporation without reimbursement from the owners of such stock. (Deductible by the corporation but not by the stockholder.)

Excess profits taxes may be "credited."—Section 236 of the law provides that excess profits taxes may be credited in computing the income tax. Since no excess profits tax is payable for the year 1922, the law, regulations, rulings and discussions pertaining thereto are omitted. For a full discussion see *Income Tax Procedure,* 1922, pages 940-942.

Foreign taxes paid may be deducted from taxes assessed in United States.—Subject to certain restrictions contained in section 222, quoted below, income or excess profits taxes paid during the taxable year to a foreign country or to any possession of the United States may be deducted from the amount determined to be due to the United States. This does not mean that such taxes are a deduction from or credit against net income, but that the items are a deduction from the amount of *taxes* otherwise payable. The amount to be credited is not to exceed the same proportion of the tax against which credit is taken, which the foreign income is of the total net income [see section 222 (a-5) below].

INDIVIDUALS.—

LAW. Section 222. (a) That the tax computed under Part II of this title shall be credited with:

(1) In the case of a citizen of the United States the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country or to any possession of the United States; and

(2) In the case of a resident of the United States, the amount of any such taxes paid during the taxable year to any possession of the United States; and

(3) In the case of an alien resident of the United States, the amount of any such taxes paid during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(4) In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership or the estate or trust paid during the taxable year to a foreign country or to any possession of the United States, as the case may be. . . . .

(b) If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Commissioner, who shall redetermine the amount of the tax due under Part II of this title for the year or years affected, and the amount of tax due upon such redetermination, if any, shall be paid by the taxpayer upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the taxpayer to give a bond with sureties satisfactory to and to be approved by the Commissioner in such penal sum as the Commissioner may require, conditioned for the payment by the taxpayer of any amount of tax found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(c) These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources without the United States, and all other information necessary for the verification and computation of such credits.

(d) If the taxpayer makes a return for a fiscal year beginning in 1920 and ending in 1921, the credit for the entire fiscal year shall, notwithstanding any provision of this Act, be determined under the provisions of this section; and the Commissioner is authorized to disallow,

in whole or part, any such credit which he finds has already been taken by the taxpayer.

The above section refers to taxes "paid." However, article 381 provides for applying the credit in respect of taxes "paid or accrued."

RULING. Any income, war profits or excess-profits taxes paid by a citizen of the United States in 1918 to a foreign country, with respect to income received from sources therein, are an allowable credit under section 222 (a) of the Revenue Act of 1918 against the amount of the tax due to the United States for that year, provided the taxpayer's books of account are kept on a cash-receipt and payment basis and a return is rendered on that basis; if the taxpayer's books are kept on an accrual basis, and his returns are so rendered, the credit for taxes paid to a foreign country on income received from sources therein will be limited to taxes accrued in the taxable year for which the return is rendered. . . . . (C. B. 2, page 196; O. 987.)

LIMITATION OF CREDIT FOR TAXES PAID TO FOREIGN GOVERNMENTS AND POSSESSIONS OF THE UNITED STATES.—

LAW. Section 222. (a) . . . . **(5) The above credits shall not be allowed in the case of a citizen entitled to the benefits of section 262; and in no other case shall the amount of credit taken under this subdivision exceed the same proportion of the tax, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits and excess-profits taxes imposed by any foreign country or possession of the United States) from sources without the United States bears to his entire net income (computed without such deduction) for the same taxable year. . . . .**

Section 262 refers to those receiving most of their income from sources within United States possessions. (See Chapter XLI.)

A citizen of Canada residing in the United States receives a net income of $40,000, of which $20,000 is net income in Canada and $20,000 is net income in the United States. The Canadian income tax is $1,300. The net income from sources without the United States, not deducting the Canadian income tax, is $20,000. The entire net income from all sources is $40,000. The proportion of the foreign income to the total income is ½. The United States tax is $1,800. The limit for the credit for foreign taxes against this tax is, therefore,

½ of $1,800, or $900. Hence, the taxpayer cannot take credit for the full $1,300 paid to the Canadian government, but only for $900 thereof. In other words, the maximum credit deductible is that proportion of the United States tax which the foreign net income bears to the total net income. The maximum, of course, cannot exceed the actual amount of the foreign tax. The $400 of foreign tax not allowed as a credit against United States tax is, however, allowed as a deduction in computing total net income [section 214 (a-3-b)].

Taxes on foreign dividends.—

Ruling. Where under a foreign income tax law corporations are required to withhold a fixed percentage of the total amount of dividends paid to the stockholders in this country, such tax being withheld in a lump sum, although imposed upon the individual stockholders, the amounts withheld not being itemized by the foreign government, in lieu of the individual tax receipts required to be attached to Form 1116, the taxpayer may attach to the return on Form 1116 his affidavit showing the number of shares held during the year, whether or not any of the shares held by him were acquired or sold during the year, giving dates and number of shares so acquired or sold; the total number of shares outstanding on which the dividend was declared regardless of whether the dividend was paid to citizens of the United States or other governments; and the total dividends paid or accrued on such shares during the year, and attach to and make a part of such affidavit a certified copy of the tax receipts from the foreign tax collector showing the payment of the tax en bloc, with copies of any other documents which he may have that will serve to corroborate the facts set forth in such affidavit.

The amount of the credit claimed should be computed by dividing the total tax withheld by the total number of shares of the corporation outstanding and multiplying this result by the number of shares held during the entire year. In the event that any of the shares were acquired or disposed of during the year, an adjustment should be made showing the amount of taxes properly allocated to the dividends received after acquisition or before disposition of the stock. (C. B. 1, page 188; O. D. 232.)

Countries which do and do not allow United States citizens who are residents a credit for the amount of income and profits taxes paid to the United States.—

Regulation. (*a*) The following is an incomplete list of the countries which satisfy the similar credit requirement of section 222

(a) (3) of the Revenue Act of 1921, either by allowing to citizens of the United States residing in such countries a credit for the amount of income, war profits, or excess profits taxes paid to the United States, or in imposing such taxes, by exempting from taxation the incomes received from sources within the United States by citizens of the United States residing in such countries: Bulgaria, Canada, Italy, Newfoundland, Salvador. (*b*) The following is an incomplete list of the countries which do not satisfy the similar credit requirement of section 222 (a) (3) of the Revenue Act of 1921, either by allowing no credit to citizens of the United States residing in such countries, for the amount of income, war profits, or excess profits taxes paid to the United States, or because such countries do not impose any income, war profits, or excess profits taxes: Argentina, Bahama, Belgium, Bermuda, Bolivia, Bosnia, Brazil, Chile, China, Costa Rica, Dutch Guiana, Ecuador, Egypt, Finland, France,[2] Great Britain and Ireland, Guatemala, Herzegovina, India, Jamaica, Japan, Montenegro, Morocco, New Zealand, Nicaragua, Panama, Paraguay, Persia, Peru, Portugal, Rumania, Santo Domingo, Serbia, Siam, Straits Settlements, Sweden, Switzerland, Venezuela. The former names of certain of these territories are here used for convenience in spite of the actual or possible change in the name or sovereignty. A resident of the United States who is a citizen or subject of any country in the first list is entitled, for the purpose of the total tax due the United States for 1921 (as to fiscal years beginning in 1920, see art. 386) and subsequent years, to a credit for the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country. If he is a citizen or subject of any country in the second list, he is not entitled to such credit. If he is a citizen or subject of a country which is in neither list, then to secure the desired credit he must prove to the satisfaction of the Commissioner that his country satisfies the similar credit requirement of the statute. (Art. 385.)

The above list has been extended during 1922 as follows:

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[2] [Former Procedure] The following special decision has been published affecting taxes paid to France:

RULING. In accordance with section 222 (a) 1 of the Revenue Act of 1918, an American citizen may credit the amount of Federal tax with the amount of any income, war profits, and excess-profits taxes paid during the taxable year to France, provided such tax paid to France is on income from sources therein. If, however, the tax paid to the Government of France is imposed on an amount fixed at seven times the rent of his residence in France (whether because he actually receives no income or insufficient income from France), such tax would be considered not to have been imposed on income from sources therein, and, therefore, not a proper credit under section 222(a) of the Act. The tax would, however, be a proper deduction under section 214 (a) 3. (C. B. 5, page 194; O. D. 1093.)

Austria,[3] Colombia,[4] Norway,[5] and Sweden,[6] satisfy the equivalent exemption provision of section 213 (b-8). Germany[7] does not satisfy such equivalent exemption provision.

RULING. A resident of the United States, being a citizen of a foreign country which satisfies the similar credit requirement of section 222 (3), is allowed as a credit against his normal tax liability his proportionate share of the taxes paid by the executor of the estate of which he is beneficiary to the foreign country, subject to the provisions of section 222 (a) 5 and (c). (C. B. I-1, page 225; Digest I. T. 1234.)

PORTION OF INCOME TAX PAID TO FOREIGN GOVERNMENT BY CITIZEN OR RESIDENT OF UNITED STATES NOT ALLOWED AS A CREDIT IS AN ALLOWABLE DEDUCTION.—Any amount of tax not allowed as a credit against tax payable to the United States under section 222 (a), as the result of the limitation imposed by section 222 (a-5), is allowed as a deduction in computing net income under section 214 (a-3-b).[8]

CORPORATIONS.—

LAW. Section 238. **(a) That in the case of a domestic corporation the tax imposed by this title, plus the war-profits and excess-profits taxes, if any, shall be credited with the amount of any income, war-profits, and excess-profits taxes paid during the same taxable year to any foreign country, or to any possession of the United States:** ***Provided,*** **That the amount of credit taken under this subdivision shall in no case exceed the same proportion of the taxes, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits, and excess-profits taxes imposed by any**

[3] I-40-539; I. T. 1463.
[4] C. B. I-1, page 202; I. T. 1248.
[5] C. B. I-1, page 111; I. T. 1328.
[6] C. B. I-1, page 111; I. T. 1327.
[7] I-37-502; I. T. 1445.
[8] [Former Procedure] Taxes imposed by a foreign country on income from sources within the United States were *not* credits against the tax due to the United States under the 1918 law. Section 222 (a) (1) of that law specified that to be credits such taxes must have been assessed on "income derived from sources therein."

RULING. Income and war-profits taxes paid to a foreign country by a citizen of the United States residing in such foreign country on income from sources within the United States can not be treated as a credit for taxes under section 222. Such taxes are deductible under section 214 (a) (3) in computing net income in his return to the United States. (C. B. 1, page 188; O. D. 317.)

foreign country or possession of the United States) from sources without the United States bears to its entire net income (computed without such deduction) for the same taxable year. In the case of domestic insurance companies subject to the tax imposed by section 243 or 246, the term "net income," as used in this subdivision means net income as defined in sections 245 and 246, respectively. . . .

The limitation on the credit mentioned above is the same as in the case of citizens or residents. For detailed computation see page 886.

The provisions of the law regarding the differences between taxes paid and the amounts previously accrued therefor, information to be furnished, and fiscal years, are the same for corporations as for individuals. (See page 880.)

Credit for taxes when domestic corporation owns control in foreign subsidiary.—

Law. Section 238. . . . . (e)[9] For the purposes of this section a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends (not deductible under section 234) in any taxable year shall be deemed to have paid the same proportion of any income, war-profits, or excess-profits taxes paid by such foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits: *Provided,* That the credit allowed to any domestic corporation under this subdivision shall in no case exceed the same proportion of the taxes against which it is credited, which the amount of such dividends bears to the amount of the entire net income of the domestic corporation in which such dividends are included. The term "accumulated profits" when used in this subdivision in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war-profits, and excess-profits taxes imposed upon or with respect to such profits or income; and the Commissioner with the approval of the Secretary shall have full power to determine from the accumulated profits of what year or years such dividends were paid; treating dividends paid in the first

[9] [Former Procedure] Under the 1918 law [section 240 (c)] the foreign income tax to be allowed as a credit was such tax "paid," not "accrued," within the taxable year. The portion of such tax deductible was based on the ratio of the dividends received from such foreign corporation to its total net income. The limitation imposed was that such credit should not exceed the amount of dividends received from such foreign corporations. For detailed discussion see *Income Tax Procedure,* 1921, pages 752-755.

sixty days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings. In the case of a foreign corporation, the income, war-profits, and excess-profits taxes of which are determined on the basis of an accounting period of less than one year, the word "year" as used in this subdivision shall be construed to mean such accounting period.

(f) For the purposes of this section a corporation entitled to the benefits of section 262 or 264[10] shall be treated as a foreign corporation.

In order to prevent a domestic corporation from securing credit against its United States tax for foreign income and profits taxes paid by a foreign subsidiary in a disproportionate degree, a limitation similar to that imposed upon taxpayers paying foreign income taxes directly was included in the 1921 law. This limitation is based on the theory that the foreign tax credited against the United States tax should be at the same rate with respect to foreign income as the United States tax is to United States income. In other words, it was felt that it would not be equitable to allow full credit for foreign tax against United States tax if the foreign taxes were imposed at a higher rate than the United States tax.

To illustrate the limitation on the credit for foreign tax contained in the 1921 law, viz., the proportion of United States tax equal to the ratio of dividends received from the foreign corporation to total net income (including such dividends) of the domestic corporation, assume the following: A domestic corporation (A) owns the entire capital stock of a foreign corporation (B):

Net income of A	$100,000 (a)
United States income and profits taxes payable by A	$ 10,500
Net income of B	$ 20,000
Foreign income and profits tax payable by B	4,000
Balance of accumulated profits available for dividends	$ 16,000 (b)
Dividend paid by B to A	$ 10,000 (c)

Ratio of (c) to (b) = 5/8 (d)
Ratio of (c) to (a) = 1/10 (e)

[10] Section 264 deals with "China Trade Act Corporations," see page 361.

The foregoing ratios are used in determining whether the limitation of tax indicated by (e) will preclude the full allowance indicated by (d).

Foreign taxes paid "with respect to the accumulated profits" of $16,000, i. e., $4,000.	
⅝ thereof (see above) = foreign taxes allocated to dividend paid to United States parent corporation	$2,500
But credit must not exceed 1/10 of United States tax ($10,500)	1,050
Amount of foreign tax disallowed as a credit	1,450

It would seem, therefore, that the United States tax payable by the domestic corporation would be $9,450 ($10,500 — $1,050). In other words, the limitation applies.

It has been suggested that the phrase in section 238 (e) "upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid," might limit the credit for taxes as shown in the above illustration to an amount allocated to the $16,000 of profits remaining after deduction of the foreign tax of $4,000, i. e., to 16/20 of the $4,000, or $3,200. Such an interpretation of the law, however, is not warranted because the entire amount of foreign tax was paid by the foreign subsidiary in respect of the profits remaining available as dividends.

It is important also to note the difference in treatment of the deduction from United States income of any part of the foreign tax disallowed as a credit. A United States corporation with a foreign branch (unincorporated) is permitted to deduct such an amount as section 234 (a-3) provides for the deduction of "Taxes paid or accrued within the taxable year except . . . . (b) so much of the income, war profits and excess profits taxes imposed by the authority of any foreign country or possession of the United States as is allowed as a credit under section 238, ..." But a United States corporation conducting its foreign business through a foreign subsidiary is not allowed as a deduction from its United States income any foreign tax paid by the foreign subsidiary which is disallowed as a credit against the United States tax of the domestic corporation.

The reason for this is that the deduction for taxes paid, under section 234 (a) quoted above, is allowed only to the taxpayer paying such taxes. In the case of a foreign subsidiary the foreign tax is paid by such foreign corporation and not by the United States corporation.

REGULATION. . . . . A domestic corporation [owning a majority of the voting stock of a foreign corporation] seeking such credit must comply with those provisions of subdivision (a) of article 383 which are applicable to credits for taxes already paid, except that in accordance with article 611 the form to be used is Form 1118 instead of Form 1116.[11]

For the purposes of section 238 a corporation entitled to the benefits of section 262 is treated as a foreign corporation. (Art. 612.)

MEANING OF TERMS.—

REGULATION. "Amount of . . . . taxes paid during the taxable year" means taxes proper (no credit being given for amounts representing interest or penalties) paid or accrued during the taxable year on behalf of the individual claiming credit. "Foreign country" includes within its meaning any foreign sovereign state or self-governing colony (for example, the Dominion of Canada), but does not include a foreign municipality (for example, Montreal) unless itself a sovereign State (for example, Hamburg). "Any possession of the United States" includes, among others, Porto Rico, the Philippines and the Virgin Islands. . . . . (Art. 382.)

The definition in the foregoing regulation of the phrase "to any foreign country," is no doubt technically correct, but it probably does not carry out the intention of Congress. In the first edition of Regulations 45 the term used was, "any

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[11] [Former Procedure] For procedure as to foreign taxes prior to 1916, see footnote, page 878.

RULING. A domestic corporation owning a majority of the voting stock of a foreign corporation is not entitled to credit for taxes paid by such foreign corporation to any foreign country or possession of the United States which are not actually paid within the taxable year of the domestic corporation . . . . (C. B. 1, page 237; T. B. R. 36.)

Space does not permit comment on the foregoing ruling. It may be entirely sound; but the author is not convinced by the arguments in the detailed ruling that Congress intended to allow credits for such taxes ("many foreign taxes which accrued prior to 1918 remain unpaid") paid in 1918 and in subsequent years, although they accrued prior to 1918.

governmental authority,"[12] which more nearly accords with the accepted meaning of "any foreign country." The Treasury has not been consistent in its definitions of "foreign government" and "foreign country." The section of the law setting forth the items not included in gross income reads:

LAW. Section 213. That for the purposes of this title . . . . the term "gross income"—

(b) Does not include . . . .

(5) The income of foreign governments received from investments in the United States. . . . .

Article 86 reads as follows:

REGULATION. The exemption of income of foreign governments applies also to their political subdivisions. . . . . (Art. 86.)

There is no sound reason why "foreign government" in section 213 should be construed to include political subdivisions, whereas the term "foreign country" used in sections 222 and 238 is construed to exclude such subdivisions.

It is customary to refer to "state" income taxes and it is quite conceivable that in a federal statute state income taxes might be specifically mentioned as being deductible. But if subsequently the city of New York were to impose an income tax and a taxpayer who had been paying $1,000 to the state thereafter paid $500 to the state and $500 to the city the courts would probably hold that since a city is an instrumentality of a state, income taxes paid to a city would be deductible.

If a citizen of the United States who now pays a $1,000 income tax in England hereafter should pay $500 direct to the British government and $500 to the city of London the regulation would prohibit the deduction of the amount paid to London, even though the change merely represented an adjustment of a policy of apportionment.

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[12] [Former Procedure]

REGULATION. " . . . . Foreign country" means any governmental authority, not that of the United States or any part or possession thereof, having power to impose such taxes, and it therefore includes a self-governing colony, such as the Dominion of Canada. . . . . (Reg. 45, April, 1919, Art. 382.)

In the opinion of the author the words "to any foreign country" mean "to any foreign country or any subdivision of a foreign country which has or may receive authority to impose an income tax."

The intention of the law was to reduce the burden on a citizen of the United States who might be taxed very heavily on income arising in a foreign country. It would seem to make little or no difference whether such foreign tax were imposed by a municipality or by a recognized sovereign government.

The following decision indicates the present interpretation of the Treasury.

Ruling. The term "foreign country" as used in sections 238 (a) and 234 (a) (3) of the Revenue Act of 1918 is held to mean the composite whole made up of all the subdivisions of a foreign State subject to the same central control. Each of the subdivisions, in this sense, is not a "country" but a part of a "country." The Province of British Columbia, therefore, does not come within the meaning of the term "foreign country" as contemplated by the statute.

Amounts of mineral tax and income tax paid or accrued to the Province of British Columbia by a domestic corporation are deductible as business expenses from the taxable income of the corporation. (C. B. 5, page 194; O. D. 1050.)

Procedure for securing credit for foreign taxes.—

Regulation. (*a*) When credit is sought for income, war profits or excess profits taxes paid other than to the United States, the income tax return of the individual must be accompanied by Form 1116, carefully filled in with all the information there called for and with the calculations of credits there indicated, and duly signed and sworn to or affirmed. When credit is sought for taxes already paid the form must have attached to it the receipt for each such tax payment. When credit is sought for taxes accrued the form must have attached to it the return on which each such accrued tax was based. This receipt or return so attached must be either the original, a duplicate original, a duly certified or authenticated copy, or a sworn copy. In case only a sworn copy of a receipt or return is attached, there must be kept readily available for comparison on request the original, a duplicate original or a duly certified or authenticated copy. (b) In the case of a credit sought for a tax accrued but not paid, the Commissioner may require as a condition precedent to the allowance of credit a bond from the taxpayer in addition to Form 1116. If

such a bond is required, Form 1117 shall be used for it. It shall be in such penal sum as the Commissioner may prescribe, and shall be conditioned for the payment by the taxpayer of any amount of tax found due upon any redetermination of the tax made necessary by such credit proving incorrect, with such further conditions as the Commissioner may require. This bond shall be executed by the taxpayer, his agent or representative, as principal, and by sureties satisfactory to and approved by the Commissioner. . . . . (Art. 383.)

Form 1116 provides for the calculation of such tax in terms of foreign money and its conversion into United States money, but does not state what rate of exchange is to be used. The form does specify, however, that claimant must "attach a statement describing in reasonable detail why and how he determined upon this particular rate."

The Treasury has ruled[13] in the case of income credited that the rate of exchange prevailing at the time the amounts were credited should be used. This is of importance in these days of highly variable exchange rates. It therefore seems proper to use the prevailing exchange rate on the date or dates when taxes were actually paid to the foreign countries.

Credit for foreign taxes under fiscal year basis.[14]—In case of fiscal years 1920 to 1921, the credit is computed for the full year under the 1921 law, and the portion thereof not already claimed is allowed [section 238 (d)].

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[13] Letter to Herbert M. Teets, New York, N. Y., signed by Deputy Commissioner L. F. Speer, dated January 11, 1916; also C. B. 3, page 234; O. D. 809.

[14] [Former Procedure]

Ruling. A domestic corporation which derives its entire income from operations in Cuba and keeps its books on an accrual basis, may file on Form 1118 a "claim for credit" of the amount of any Cuban income, war profits or excess profits tax accrued for the fiscal year ended June 30, 1918, and apply such credit against its Federal income and profits tax for the same fiscal period. This credit should be prorated with reference to that part of the fiscal year falling within the calendar year 1918. If the 1918 Federal tax has been paid without claiming this credit and the company wishes to credit the overpayment against the 1919 taxes, Form 1118 should be accompanied by a claim for refund on Form 46 and possibly a claim for credit on Form 47-A.

A claim for credit on Form 1118 for the amount of Cuban income, war profits or excess profits tax accrued for the fiscal year ended June 30, 1919, may be filed and applied against the company's Federal tax liability for the same fiscal period. (C. B. 2, page 221; O. D. 406.)

See also section 238 (c), 1918 law.

WHEN AMOUNTS SUBSEQUENTLY PAID DIFFER FROM ACCRUALS.—

REGULATIONS. In case credit has been given for taxes accrued, or a proportionate share thereof, and the amount that is actually paid on account of such taxes, or a proportionate share thereof, is not the same as the amount of such credit, or in case any tax payment credited is refunded in whole or in part, the taxpayer shall immediately notify the Commissioner. The Commissioner will thereupon redetermine the amount of the income tax of such taxpayer for the year or years for which such incorrect credit was granted. The amount of tax, if any, due upon such redetermination shall be paid by the taxpayer upon notice and demand by the collector. The amount of tax, if any, shown by such redetermination to have been overpaid shall be credited against any income, war profits or excess profits taxes, or instalment thereof, then due from such taxpayer under any other return, and any balance of such amount shall be immediately refunded to him. . . . . (Art. 384.)

. . . . To secure such a credit a domestic corporation must pursue the same course as that prescribed for an individual by article 383, except that Form 1118 is to be used for claiming credit and Form 1119[15] for the bond, if a bond be required. For the redetermination of the tax, when a credit for such taxes has been rendered incorrect by later developments, see article 384, all of the provisions of which apply with equal force to a corporation taxpayer. For credit where taxes are paid by a foreign corporation controlled by a domestic corporation, see article 612. A claim for credit in such a case is also to be made on Form 1118. . . . . (Art. 611.)

RULING. A corporation has a legal right under section 12 (a) Fourth of the Act of October 3, 1917, to accrue upon its books moneys for foreign taxes and take the same as a deduction from its gross income for 1916 and 1917, and under section 238 (a) and (b) of the Revenue Act of 1918 to accrue said taxes upon its books and credit them against its tax liability due the United States of America for the years 1918 and 1919.

It should not be deprived of the right to deduct or obtain credit for foreign taxes on account of the fact that the exact amount of taxes were not definitely ascertainable at the time of the accrual. (I-34-469; Digest A. R. M. 173.)

This ruling will also apply under the 1921 law.

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[15] See Appendix of *Excess Profits Tax Procedure*, 1921, for reproduction of form.

FORMS TO BE USED BY INDIVIDUALS AND PARTNERSHIPS WHEN CREDIT FOR FOREIGN TAXES IS CLAIMED.—

RULING. A domestic partnership has leased certain of its patents to a British licensee for a fixed royalty, and the British government requires the licensee to withhold and pay to it the British income tax on the royalty payments.

The partners, in order to obtain credit for such tax paid to the British Government, should attach to the return of the firm on Form 1065 a claim for credit, Form 1118, modified throughout by substituting the word "partnership" for the word "corporation." In lieu of the required receipt or return, a copy of the receipt issued to the British licensee showing the payment of tax made to the British Government, duly attested by the president of the British licensee, will be accepted. The individual members of the partnership are required to attach Form 1116 to their individual returns, accompanied by a copy of the receipt issued to the British licensee and a copy of the affidavit made by the president of the British licensee. (C. B. 3, page 220; O. D. 583.)

When a partnership pays income or excess profits taxes to a foreign country, the tax so paid is not to be included as an expense in form 1065,[16] but is to be allocated to the individual partners on the same basis as the profits. The amounts may, subject to the limitations already mentioned, be deducted by the partners from the *tax* computed on their individual returns. Only the difference, if any, between the foreign tax so credited and the total amount of such foreign tax, is to be entered in form 1065 and thus be deducted from gross income in computing net income subject to United States income tax.

MASSACHUSETTS TRUST OPERATING PROPERTY IN A FOREIGN COUNTRY.—Where, under the laws of a foreign country, taxpayers are taxed as individuals, although in this country they would be and are regarded as an association, the individuals who were actually assessed by the foreign government must claim credits against their individual income taxes, and the association not having paid the tax cannot claim the credit.

RULING. . . . A Massachusetts trust, taxable as an association, owns and operates property in a foreign country, which does not

[16] For copy of form, see Appendix B of *Income Tax Procedure*, 1922.

recognize the separate entity of the association but regards it as a partnerships, the shareholders paying income tax individually to the foreign country upon their respective shares of the net profits of the association.

Held, that the association is not entitled to claim under the Revenue Act of 1918, as a credit on Form 1116, the amount of the taxes so paid by the shareholder, but that the shareholders who paid such taxes are entitled to the credit within the limitation of article 381, Regulations 45. (C. B. 5, page 230; Digest A. R. R. 643.)

Tax on bank stock, etc., no longer deductible by shareholders.—Taxes on bank stock (or similar taxes on the stock of other corporations) paid by the bank are, under the 1921 law, deductible by the bank, and not by the shareholders.[17]

Regulations. Under the Revenue Act of 1921 banks or other corporations paying taxes assessed against their stockholders on account of their ownership of the shares of stock issued by such corporations, without reimbursement from such shareholder or member, may deduct the amount of taxes so paid. The statute specifically provides, however, that in such cases the stockholders may not deduct the amount of the taxes.[18] (Art. 566.)

In computing the net income of an individual no deduction is allowed for the taxes imposed upon his interest as shareholder or member of a bank or other corporation, which are paid by the corporation without reimbursement from the taxpayer. . . . . (Art. 135.)

Rulings. The term "reimbursement" as used in section 214 (a) 3 and section 234 (a) 3 of the statute contemplates actual repayment. The transaction is to be handled according to the intention of the bank to require reimbursement. Assuming that the bank keeps its books on the accrual basis and will require reimbursement, it must accrue the amount of the tax in the year in which such tax became a liability of the bank, and also accrue the debt (in the same amount) owed by the stockholder to the bank. If reimbursement is not required, only the amount of the liability should be accrued and deduction thereof taken by the bank accordingly. (C. B. I-1, page 280; Digest I. T. 1346.)

The fact that the profits of a shareholder in a corporation are correspondingly reduced by the payment by the corporation in his behalf of taxes imposed upon his interest as a shareholder does not constitute a "reimbursement" of the corporation from the share-

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[17] See page 751.

[18] Section 214 (a-3).

holder within the meaning of section 214 (a) 3 of the Revenue Act of 1921. (C. B. I-1, page 141; Digest I. T. 1255.)

Amounts advanced by a corporation to its shareholders to pay taxes assessed against the shareholders, because of ownership of the shares, are not deductible in computing the net income of the corporation. (I-31-442; Digest I. T. 1407.)

State banks may, but national banks may not, deduct taxes paid under section 4273 of the Statutes of Mississippi, as amended by the Act of March 19, 1920, in computing income under the Revenue Act of 1918.

Under section 234 (a) of the Revenue Act of 1921, a State Bank may deduct taxes imposed by said amended section 4273, and a national bank may deduct taxes imposed by such amended section which have been paid by it under the conditions set forth in section 234 (a) 3 of the Revenue Act of 1921. (C. B. I-1, page 277; Digest I. T. 1208.)

If national banks in Rhode Island elect to pay the taxes assessed against the depositors on savings deposits, filing the required stipulation with the board of tax commissioners setting forth such fact, and received no reimbursement from the depositors, such banks may claim the taxes so paid as business expenses in their returns. Each depositor will then be required to report as taxable income the tax paid on his deposit, but may deduct the amount as taxes paid. (I-28-401; Digest I. T. 1388.)

In the case of trust companies in Massachusetts, the State levies a tax upon their corporate franchise. The tax is assessed against such trust companies and payable by them. The amount of tax is based upon the total amount of the capital stock, surplus, and undivided profits of the companies at the time the assessment is made.

It is held that the tax levied against trust companies by the State of Massachusetts under section 58 of the New General Laws of the State is deductible by such companies for the year in which paid or accrued, depending upon whether books of account are kept on the cash receipts and disbursements basis or on the accrual basis. (C. B. 5, page 229; O. D. 1043.)

A shareholder of a bank in West Virginia may file with the assessor a claim for exemption from taxation of the stock, which tax is payable by the bank, to the extent of the indebtedness owing by the shareholder on the assessment date. Where the bank pays to the shareholder the amount of the tax which it would have paid for him to the State, such payment is in the nature of an additional dividend to the recipient.

Such an amount may not be deducted from the gross income of

the bank under section 234 (a) 3 of the Revenue Act of 1921. (C. B. I-1, page 11; Digest I. T. 1300.)

Taxes paid under secured debt laws deductible.—

REGULATION. . . . . Amounts paid to States under secured debts laws in order to render securities tax exempt are deductible. . . . . (Art. 131.)

Automobile license fees deductible.—

REGULATION. . . . . Automobile license fees are ordinarily taxes. (Art. 131.)

RULING. A taxpayer whose books are kept on the receipts and disbursements basis may deduct from gross income on his 1919 return automobile taxes levied against him by the State of Iowa for 1919 and 1920, provided he actually paid such taxes during 1919. If the books of the taxpayer are kept on the accrual basis, then only the amount of such tax applicable to the year 1919 may be taken as a deduction in preparing his 1919 income tax return, and the amount which represents the 1920 tax may be deducted on such taxpayer's 1920 return, notwithstanding the fact that he actually paid the tax for both years in 1919. (C. B. 2, page 116; O. D. 388.)

Business, excise and license taxes deductible.—

REGULATION. . . . . business, license, privilege, excise . . . . taxes paid to internal revenue collectors, are deductible as taxes imposed by the authority of the United States, provided they are not added to and made a part of the expenses of the business or the cost of articles of merchandise with respect to which they are paid, in which case they can not be separately deducted. (Art. 132.)

The foregoing regulation does not operate as a limitation upon the deduction, but merely points out that a dealer who pays these federal taxes must not deduct them twice.

The stipulation that the taxes be paid to an internal revenue collector must be regarded as explanatory. It must not be interpreted to mean that taxes to be deductible must be paid to an internal revenue collector. It simply means that taxes so paid are among the allowable deductions.

All taxes other than federal income and profits taxes and local assessments, are deductible by the taxpayer who is assessed for them and responsible for their payment. The actual payments may be made by withholding agents as in the case

of theater tickets, etc. When the tax is paid to the collector by someone other than the taxpayer, the latter is the only one who can claim the payment as a deduction.

Rulings. The Republic of Cuba imposes on all corporations operating sugar plantations in Cuba, a tax of a certain amount on each bag of sugar produced. Apparently this tax is based on production, not on income, and is in the nature of an excise tax. Therefore a domestic corporation may deduct from gross income in its return to the United States Government the amount of such tax paid to the Cuban Government but may not claim the amount as a credit against the total tax due to the United States. (C. B. 2, page 115; O. D. 372.)

The tax paid by a citizen of the United States to the Government of Latvia, measured by the amount of his living expenses while in Latvia in lieu of income received from sources within that country, although levied under the income tax law of that country, is not such a tax as may be credited against the amount of his Federal tax liability as provided by section 222 of the Revenue Act of 1921, for the reason that such tax is not imposed on or measured by his income, but by certain of his expenditures. Such tax, however, represents a proper deduction from the taxpayer's gross income as provided by section 214 (a) 3 of the Act. (I-37-501; I. T. 1444.)

Wholesale liquor dealers who exercised their option of including excise taxes in cost of merchandise in calculating inventory may not now amend such inventory and treat the taxes as business expenses. (C. B. 1, page 112; O. D. 137.)

The tax on gasoline and other products used in the propelling of motor vehicles and motor boats levied by a State is deductible by the distributors, against whom it is levied and from whom it is collectible. If the tax is made a part of the expenses of the business of the distributors or the cost of the fuel sold, it can not be deducted separately as a tax item, but may be deducted as part of the business expenses. Purchasers of the fuel for business purposes may include as a part of the cost of the fuel any addition to the price made by the distributor to cover the tax levied upon him. (C. B. I-1, page 133; Digest I. T. 1195.)

Excise and stamp taxes are deductible only by the one against whom such taxes are levied.—

Ruling. Receipt is acknowledged of your letter of February 28, 1920, in which you inquire as to the taxpayer who is entitled to the

benefit of a deduction from gross income in respect of excise and stamp taxes levied by the federal government.

In reply you are advised that the general rule which applies in respect of a deduction for all taxes is that the deduction may be taken only by the person against whom such taxes are levied. The fact that one person ultimately pays a tax levied upon another does not give such person a right to the benefit of the deduction.

As to the person against whom excise and stamp taxes are levied, your attention is directed to sections 900 to 907, and 1006, 1100 to 1107, inclusive, of the Revenue Act of 1918. (Letter to Leslie, Banks & Company, New York, N. Y., signed by G. V. Newton, Acting Assistant to the Commissioner, and dated March 6, 1920.)

Customs duties deductible.—

Regulation. Import or tariff duties paid to the proper customs officers . . . . are deductible as taxes imposed by the authority of the United States, provided they are not added to and made a part of the expenses of the business or the cost of articles of merchandise with respect to which they are paid, in which case they can not be separately deducted. (Art. 132.)

The deduction may be claimed on articles intended for personal or family use as well as by dealers who buy to resell.

Stamp and similar taxes deductible.—

Regulation. . . . . stamp taxes paid to internal revenue collectors are deductible. . . . . (Art 132.)

Ruling. The amount of an American consular fee stamp placed on an invoice of merchandise imported from Great Britain into the United States during the year 1921 for personal use is not a stamp tax within the meaning of the Revenue Act of 1921.

The amount of a consular fee paid in connection with the shipment of articles named in the invoice constitutes a personal expense which is not deductible in computing net income. (C. B. I-1, page 133; I. T. 1301.)

In view of the heavy stamp and other taxes being collected by federal and state authorities, it may be worth while for taxpayers to preserve a record of the stamps used on stock transactions and for many other purposes. The payment of taxes as represented by stamp purchases is plainly an allowable deduction. Stamp taxes on certificates of stock which have been sold should be treated as taxes and not as a deduction from

the proceeds of sale.[19] Taxes payable by the manufacturer are not deductible by the ultimate consumer.

Luxury and excise taxes.—The 1921 law repealed many of the luxury and excise taxes[20] and those that remain are almost all payable by the manufacturer. In view of this it has been decided to omit from this edition of *Income Tax Procedure* any lengthy discussion on this subject such as appeared in the editions of 1921 and prior years. Although the number of taxes is still large, the test for their deductibility or otherwise is the same in all cases, viz.: Is the tax levied against the person desiring to make the deduction? If, as in the case of club dues or admissions, the tax is levied against the taxpayer, the latter can deduct it. If it is levied against the manufacturer, he includes it in his cost of production, and the consumer is not entitled to any deduction; even if the manufacturer passes the tax on to the consumer as a specific item, the consumer cannot deduct it as a tax.

Claims where accurate records of tax payments not kept.— Each taxpayer is expected to return every dollar of taxable income even though no permanent record of it was made. Similarly a taxpayer may claim credit for all taxes paid if the claim is made in good faith and can reasonably be sup-

[19] [Former Procedure] Under the 1918 law taxable income was the same whether tax stamps were treated as expenses or as taxes, but under the 1913 law and in many cases under the 1917 law stock losses were not deductible. Hence when stamp taxes on transfers of stock were treated as deductions from proceeds of sales (and the transaction resulted in a loss), credit was not secured for the item of stamp taxes, because the cost of the stamps was merged in the stock loss.

[20] [Former Procedure] Under the 1917 law taxes were imposed on a large variety of things including the following: facilities (passenger fares, freight, express, berths, seats, telegraph and telephone messages), promissory notes (except when Liberty bonds were used as collateral), conveyances of real estate, powers of attorney, proxies, admissions to theaters and other places of amusement, and dues charged by social and similar clubs.

The 1918 law modified these taxes to some degree and added the luxury tax, the tax on the retail price of jewelry, perfumes, cosmetics, etc. In addition, there were levies against a greatly extended list of articles payable by the producer on the basis of the wholesale price rather than by the consumer on the basis of the retail price.

ported. Since receipts were not usually given by those who collected the taxes, vouchers cannot be furnished. If one's memory is trustworthy no objection can be made to a claim based on the taxpayer's statement.

Ruling. An individual may claim as a deduction the amount of war tax paid on facilities furnished by public utilities, which include tax on railroad and steamship fares, and the war tax paid on admissions and dues. The war excise taxes imposed by section 904 and paid by the purchaser are deductible, but the war excise taxes imposed by section 900, which are levied against and paid by the manufacturer, producer, or importer, are not deductible by the individual purchaser. (C. B. 1, page 112; O. D. 287.)

Inheritance taxes deductible.—On June 6, 1921, the United States Supreme Court held[21] that when Congress included all taxes[22] among allowable deductions it used language which is to be taken in its ordinary meaning, and that inheritance or estate taxes paid by an estate may be deducted from taxable income.

Decision. . . . . The act of 1916 calls the estate tax a "tax" and particularly denominates it an "estate tax." This court recently has recognized that it is a duty or excise and is imposed in the exertion of the taxing power of the United States. *New York Trust Co. v. Eisner,* 256 U. S. 345. It is made a charge on the estate and is to be paid out of it by the administrator or executor substantially as other taxes and charges are paid. It becomes due not at the time of the decedent's death, as suggested by counsel for the Government, but one year thereafter, as the statute plainly provides. It does not segregate any part of the estate from the rest and keep it from passing to the administrator or executor for purposes of administration, as counsel contend, but is made a general charge on the gross estate and is to be paid in money out of any available funds or, if there be none, by converting other property into money for the purpose.

The author consistently held in all former editions of this book that, unless and until the law restricts the deductions of

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[21] *U. S. v. Alan H. Woodward, et al.,* 256 U. S. 632, 65 L. Ed. 1131, 41 Sup. Ct. 615 (C. B. 4, page 153; T. D. 3195).

[22] The suit was brought under the 1916 law under which federal income as well as all other taxes (except those for local benefits) were allowable deductions. Under later laws the only exclusions are federal income and profits taxes.

inheritance or estate taxes, the amount paid by, or for, an estate is an allowable deduction.

Regulation. Federal estate taxes, paid or accrued during the taxable year, are an allowable deduction from the gross income of the estate in computing the net income thereof, subject to tax. The whole amount of such taxes, irrespective of when paid, is deemed to have accrued on the due date thereof, namely, one year after the decedent's death (Sec. 406, Title IV, Revenue Act of 1921), and, if the accounts of the estate are kept on an accrual basis, are deductible from gross income of the taxable year in which such due date falls, or for the taxable year in which paid, if paid before the due date. If the accounts are kept on the basis of cash receipts and disbursements, deduction may be taken from gross income of the taxable year or years in which the payment or payments may have been made.

Estate, succession, legacy, or inheritance taxes, imposed by any State, Territory or possession of the United States, or foreign country, are deductible by the estate, subject to the provisions of section 214, where, by the laws of the jurisdiction exacting them, they are imposed upon the right or privilege to transmit rather than upon the right or privilege of the heir, devisee, legatee, or distributee, to receive or to succeed to the property of the decedent passing to him. Where such taxes are imposed upon the right or privilege of the heir, devisee, legatee, or distributee, so to receive or to succeed to the property, they constitute, subject to the provisions of section 214, an allowable deduction from his gross income.

Where, in accordance with a direction contained in the testator's will, the taxes upon the right to receive any particular devise or devises, legacy or legacies are so payable as to relieve the particular devisee or devisees, legatee or legatees from the burden thereof, then the person or persons entitled to the fund or other property out of which payment is made may not take deduction of the taxes so paid, but deduction thereof is available only by such devisee or devisees, legatee or legatees; each, if there be more than one, being authorized to deduct such part of the taxes so paid as he would otherwise have been entitled to do had there been no such testamentary direction.

Where there is a life estate and a remainder, and, by the laws of the jurisdiction imposing them, the taxes in respect to both interests are payable out of the remainder interest, with no legal obligation imposed whereby the remainderman is entitled to reimbursement, then deduction of the taxes so paid may be taken only by the remainderman. Where, in the case of an annuity, the taxes in respect thereto are, by the laws of the jurisdiction imposing them, payable in the first instance out of the fund set aside for creating the annuity, but are to be repaid or restored to such fund from the annuity, then deduction thereof may be taken only by the annuitant.

The accrual dates of such taxes shall be the due date thereof except as otherwise provided by the law of the jurisdiction imposing them. Where deduction is claimed of any such taxes, the amount thereof and the name of the State, Territory, or possession of the United States, or foreign country, by which they have been imposed shall be stated in the return. (Art. 134, as amended by T. D. 3411, dated November 24, 1922.)

The regulation points out the conditions under which the right to deduct inures to the estate and when to the distributees. For instance, when legacies are made payable free of tax, and the estate pays the tax for the legatee, it is held that the latter and not the estate is entitled to the deduction. The same principle is applied to remaindermen and annuitants. The deduction is complicated by the procedure in the local jurisdiction in which the estate is administered. It may be expected, therefore, that the foregoing regulations will be amended from time to time.

It should be noted that when the accounts of an estate are on a cash basis, the tax may be deducted in the year paid, even if such date is prior to the date when the tax is deemed to have accrued.

Under no circumstances can the tax be deducted in the return of the decedent[23] nor in the executor's personal return when paid by the latter after the estate was closed.[24]

Rulings. If the books of an estate are kept on the basis of cash receipts and disbursements, the Federal estate tax is an allowable deduction in the income tax return only for the year in which the tax was paid. (C. B. I-1, page 140; Digest I. T. 1364.)

Death duties imposed by the Minnesota statutes are not deductible from the gross income of the estate but may be taken as a deduction by the several legatees in such sums respectively as represent the amount of tax determined by the legacy received by each. These duties accrue at the date of decedent's death. (C. B. I-1, page 139; Digest I. T. 1296.)

The State of Rhode Island imposes death duties of two kinds: One of such duties being laid upon the "net estate" of the decedent "as a tax upon the right to transfer" and the other as an inheritance

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[23] *Catherwood v. U. S.*, 280 Fed. 241.
[24] I-34-465; I. T. 1424.

tax "upon the right to receive." The former is deductible from the gross income of the estate. The latter is deductible from the gross income of each beneficiary in the amount of the tax paid in respect to the share or portion of the estate passing to him. (C. B. I-1, page 139; Digest I. T. 1295.)

Taxes paid for another person—who deducts?—Credit should be taken for taxes by the owner of the property taxed; but if a husband pays the taxes on a residence the title to which is in the name of his wife there appears to be no prohibition in the law against the deduction by the husband in his return. Strictly speaking, the payment represents a gift to the wife and should be deducted by her.

However, the general rule is "that where one taxpayer pays a tax that is levied upon another he may not deduct such taxes from his income." (See I-46-592; A. R. R. 1020, and cases cited therein.)

Taxes paid by trustees.—When trustees fail to pay estate and inheritance taxes and the estate is distributed and the beneficiaries subsequently pay the taxes, the latter may not deduct the payments, since they are in effect volunteers. (I-46-592; A. R. R. 1020.) The ruling fails to suggest that the trustees should reopen their accounts, pay the tax and file amended returns.

Tax deductions too broad.—In the opinion of the author not all taxes deductible under the law are logical deductions. For example, a tax paid upon an individual's own residence, the rental value of which is not taxable, is an allowable deduction, although such a tax clearly is a living or personal expense. This may be said to be true also of luxury taxes and of import duties paid by individuals on goods destined for their personal consumption. It would be more equitable if taxes were deductible only when paid on income-producing property or on property acquired for income-producing purposes.

Taxes Not Deductible

The law permits the deduction from gross income of all taxes levied by the authorities enumerated, with four specific exceptions, viz., the federal income tax, the excess profits tax,[25] a proportionate part of foreign income and excess profits taxes (which are a credit against United States taxes), and certain types of special assessments. Consequently the procedure at this point resolves itself largely into the problem of determining whether or not particular expenditures are taxes.

Federal income tax cannot be deducted.—In 1917 the practice of permitting the deduction of federal income taxes was abandoned.[26] They are no longer deductible.

ADJUSTMENT OF TAXES OF PRIOR YEARS.—When there is an adjustment of returns for years prior to 1917 and the in-

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[25] [Former Procedure] The excess profits tax which was discontinued at December 31, 1921, was credited against net income in computing the income tax.

[26] [Former Procedure]

Deductibility of 1916 income taxes accrued on portion of fiscal year ending in 1917.—Federal income taxes were deductible before 1917. The law forbidding the deduction was passed October 3, 1917. It was the intention of Congress to apply the restriction to the new income and excess profits taxes, and the restriction was a perfectly sound one, but there was no intention to forbid a taxpayer to take credit for accrued 1916 federal income taxes. For comments and suggestion, see *Income Tax Procedure,* 1920, pages 614-615.

RULING. Additional excise taxes assessed against a corporation under the Revenue Act of 1909 and paid during subsequent years are allowable deductions from the gross income reported on the corporation's return for the year in which paid; but income taxes assessed under the Revenue Acts of 1913 or 1916 are deductible only if paid prior to January 1, 1917. (C. B. 1, page 111; O. D. 240.)

The foregoing ruling is erroneous. T. D. 2433 (January 8, 1917) permitted the deductions of 1916 taxes accrued December 31, 1916, but not paid.

In one case the Treasury disallowed the deduction. The author carried the matter to the Court of Claims and secured a judgment.

In A. R. R. 1082 (I-35-481) it was held that 1916 taxes were deductible even if not accrued by a taxpayer who keeps books on an accrual basis as to all items other than taxes.

come tax is redetermined, the additional tax paid or the refund received may require a further adjustment of taxes for the *succeeding* year or years.

PENALTY ADDITIONS TO TAXES MAY OR MAY NOT BE DEDUCTIBLE.—

RULING. (1) The addition to tax authorized to be assessed by section 3176, Revised Statutes, as amended, on delinquent or false and fraudulent returns is to be considered a penalty and not a tax except for purposes of collection.

(2) Such an addition to tax made on excess profits tax returns is not an allowable credit in arriving at the net income subject to normal income tax.

(3) The payment of such an addition to tax is not to be disallowed as a deduction from gross income in obtaining net income on the ground that it is a part of the income or profits tax within the provisions of law forbidding the deduction from gross income of those taxes.

(4) The payment of an addition to tax for delinquency in filing a return may be deducted from gross income as a business expense when such an addition to tax is an incident to carrying on a business or trade. The payment of an addition to tax upon a false or fraudulent return may not ordinarily be deducted from gross income as a business expense and may never be deducted in the case of an individual who himself was guilty of making a fraudulent return. . . . (C. B. 1, page 241; O. 926.)

Special assessments may or may not be deductible.— Taxes which may not be deducted include "those assessed against local benefits of a kind tending to increase the value of the property assessed."[27] The provision which broadens the deduction so as to include assessments which do not increase the value of the property appeared for the first time in the 1918 law and is an improvement over former procedure.[28]

[27] Section 214 (a-3-c).

[28] [Former Procedure] The 1918 law was the same in this respect as the present law. The laws of 1917 and of prior years excluded as deductions all taxes assessed against local benefits. [See 1917 law, section 5 (a), third.]

REGULATION. So-called "taxes," more properly assessments, paid for local benefits, such as street, sidewalk, and other like assessments, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied, do not constitute an allowable deduction from gross income. Taxes deductible are those levied for the

Regulation. So-called taxes, more properly assessments, paid for local benefits, such as street, sidewalk, and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied, do not constitute an allowable deduction from gross income. A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction. Assessments under the statutes of California relating to irrigation and of Iowa relating to drainage, and under certain statutes of Tennessee relating to levees, are limited to property benefited, and when it is clear that the assessments are so limited, the amounts paid thereunder are not deductible as taxes. When assessments are made for the purpose of maintenance or repair of local benefits, the taxpayer may deduct the assessments paid as an expense incurred in business, if the payment of such assessments is necessary to the conduct of his business. When the assessments are made for the purpose of constructing local benefits, the payments by the taxpayer are in the nature of capital expenditures and are not deductible. Where assessments are made for the purpose of both construction and maintenance or repairs, the burden is on the taxpayer to show the allocation of the amounts assessed to the different purposes. If the allocation can not be made, none of the amounts so paid is deductible. (Art. 133.)[29]

The regulation recognizes the distinction between capital expenditures and expense as constituting the dividing line between the deductible and the non-deductible types of special assessments. But it also goes further and attempts to apply another test of deductibility, that is, whether an assessment which is not of the nature of a capital expenditure "is neces-

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public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction.

Special assessments, such as are hereinbefore contemplated and which are measured upon the basis of the benefit flowing directly to the property, are not deductible, even though an incidental benefit may inure to the public welfare . . . . (Reg. 33, 1918, Art. 194.)

[29] [Former Procedure] The editions of Regulations 45 published early in 1919 included the following sentence: "Assessments under Illinois laws relating to drainage districts are not limited to the property benefited and assessments so paid are deductible." The expression, in the sentence which discusses the statutes of several states, "and when it is clear that the assessments are so limited," was introduced by T. D. 2937. See C. B. 1, page 112; O. D. 928.

sary to the conduct of his business." The regulation does not directly state that such assessments when imposed against non-business property are not allowable deductions, but it plainly infers this. Whatever can be said for its equity, such a position is obviously illegal. The law itself when it says "Taxes paid . . . . not including those assessed against local benefits . . . ." [section 214 (a-3)] practically defines a special assessment as a tax, and when such assessments are not "of a kind tending to increase the value of the property assessed" they are deductible, irrespective of whether they can be shown to be business expenses or not. The tax on a taxpayer's residence has always been an allowable deduction. Under the 1918 law taxes assessed against local benefits which do not increase the value of the property were also made allowable deductions, and the 1921 law is like that of 1918 in this respect.

Assessments which do not increase value of property are deductible.—There is a legal and economic distinction of long standing between taxes and special assessments. This distinction is based upon the fact that the special assessments ordinarily represent the purchase price of equipping the land with facilities, commonly called "improvements"—such as street paving, side-walks, sewers, etc. This equipment normally results in a "benefit inuring directly to the property against which the assessment is levied." The economic basis for the non-allowance of such assessments consists of the fact that they are in effect expenditures of a capital nature. But it must be recognized that this foundation disappears when the special assessments are levied for purposes transitory in character. Moreover, the use of special assessments for transitory "service" activities—such as lighting and cleaning streets, snow removal, etc.—is becoming more and more widespread. These are essentially expenses and thus are allowable deductions under the law.

Types of special assessments which can be deducted will

be found in Massachusetts, where special assessments may be levied to provide funds for street sprinkling, for protection of trees by moth extermination and for current expenses.

Of course, the element of depreciation appears in most public works, but the distinction to be made is whether or not the improvement is one which is properly of a capital nature. If not, the taxes paid on assessments are deductible.

If the improvement is of a capital nature which in time requires renewals, depreciation may possibly be claimed.

Special assessments which may not be deducted.—In the case of the permanent types of equipment, such as sewers, streets, etc., the justice of placing special assessments on a different basis from taxes depends upon whether their nature as capital expenditures is recognized. Theoretically, the buyer of a tract of land makes his purchase "on notice" that he will be called upon to pay for its equipment with sewers, roads, etc., by the special assessment method, and consequently he makes an allowance in the price he pays for the land for this additional expenditure which must ultimately be made up from the prices he will receive when he sells the lots. It is clear that he should be permitted to include all such expenditures for special assessments as capital in calculating his taxable gain for income tax purposes when he has sold his lots. Unless he fully calculated his future special assessment burden when he purchased the tract he will suffer a loss. The same principle applies to special assessments on improved property.

If there is no element "tending to increase the value of the property" the payment does not constitute a proper capital item, because the property owner would not expect to be able to add the assessment to the price of the property in case of sale.

If the assessment does tend to increase the value of the property it is not a deduction for income tax purposes, but it adds to the capital value of the property and should be so regarded in computing the gain or loss in case of sale.

Rulings. Amounts expended by an estate on account of special assessments for the maintenance or repair of streets or for sidewalk improvements levied upon property used in a trade or business, if the same is necessary in the conduct of such trade or business, constitute allowable deductions.

In case any of the property of the estate is used for residential purposes by anyone beneficially interested in the estate, the amounts expended in payment of assessments levied upon such property for maintenance and repairs can not be deducted by the estate unless the rental value of the property is included in the gross income of the estate. . . . . (C. B. 3, page 149; O. D. 613.)

The surface of a street paved with granite was, because of deterioration from traffic, replaced by using the old granite blocks with a new concrete foundation.

Held, that the assessment paid by a corporation, being for the construction of practically a new pavement, is not deductible as a business expense. (C. B. I-1, page 135; Digest I. T. 1246.)

Assessments paid by a property owner in the District of Columbia for resetting curb and repaving the street in front of his residence, which were levied under the provisions of an Act entitled "An Act making appropriations to provide for the expenses of the government of the District of Columbia for the fiscal year ending June 30, 1915, and for other purposes" (38 Stat., 517), are taxes assessed against local benefits of a kind tending to increase the value of property and as such are not deductible from gross income. (C. B. I-1, page 135; Digest A. R. R. 909.)

As stated on page 907, the author is of the opinion that taxes assessed for local benefits which do not increase the value of the property assessed are deductible.

Ruling. Assessments for local benefits paid by a tenant for his landlord according to agreement are held to be additional rent paid by the tenant, and therefore deductible from his gross income. The amount so received by the landlord is taxable income to him but because of its nature is not an allowable deduction from his gross income. (C. B. 2, page 123; O. D. 373.)

Certain so-called taxes deductible only as business expense.—In some places charges for water furnished by a municipality are known as taxes, chiefly because they are assessed by the city and become a lien on real estate if not paid. Likewise, in certain communities[30] "assessments" are laid upon

[30] For definition of "political subdivision," see page 381 *et seq.* The definition is of importance when considering items of doubtful deductibility.

residents to raise funds for fire protection, road improvement, etc. These do not bear the stamp of government action; they do not become a lien on real estate when not paid; and they are in fact voluntary purchases of certain services and equipment through a common fund. No such expenditures are deductible as taxes or as expenses except when paid as an incident to the possession of income-producing property or to a business carried on for profit.

Tax on undistributed surplus not deductible.—

RULING. Replying to your communication of March 14, 1919, you are informed that the 10 per cent tax which was imposed on corporation's undistributed net income by section 10 (b) of the Revenue Act of September 8, 1916, as amended by the Revenue Act of October 3, 1917, is not an allowable deduction from the gross income of a corporation shown on an income tax return. (Letter to The Corporation Trust Company, signed by Commissioner Daniel C. Roper, and dated April 1, 1919.)

The 10 per cent tax was a tax upon income and for that reason was not deductible.

Postage not deductible as a tax.—

REGULATION. . . . . Postage is not a tax . . . . (Art. 131.)

Postage, of course, is deductible when it is a business expense.

Federal tax paid by corporations under tax-free covenants not deductible.—The 2 per cent federal tax on "tax-free" bonds, which corporations theoretically withhold at the source, is held to be paid for account of the recipient of the interest,[31] and since it is an allowable credit to the recipient, taxes so paid are not deductible by the corporation.

REGULATION. Corporations may deduct taxes from gross income to the same extent as individuals, except that in the case of corporate bonds or obligations containing a tax-free covenant clause, the corporation paying a Federal tax, or any part of it, for someone

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[31] For method of securing advantage of the deduction, see Chapter XXIV, "Income from Interest," page 675 *et seq.*

else pursuant to its agreement is not entitled to deduct such payment from gross income on any ground. In the case, however, of corporate bonds or obligations containing an appropriate tax-free covenant clause, the corporation paying a State tax or any other than a Federal tax for someone else pursuant to its agreement may deduct such payment as interest paid on indebtedness.[32] Under the Revenue Act of 1921 any tax paid by a corporation pursuant to a tax-free covenant clause need not be included in the gross income of the obligee. (Art. 565.)

SUGGESTION TO CORPORATIONS.—Corporations having "tax-free" covenant bonds are under no necessity to pay a tax on the interest of such bonds as are held by persons whose income is less than the personal exemption. They can make a saving by giving close attention to the form of certificates filed with them by such persons. Many bondholders with very small incomes are not careful to file the form of certificate which claims the exemption. Wherever feasible the certificates claiming exemption should be substituted for those not claiming exemption.

RULING. If an individual who received during 1917 interest on bonds containing a tax free covenant clause was not liable to the payment of normal income tax for that year, the amount of tax paid at the source in his behalf by the debtor corporation is refundable to the debtor corporation, if such tax was not actually withheld from the individual bondholder. The amount of any income or excess profits taxes, or any installment thereof, shown to be due on the debtor corporation's income and profits tax return may be credited with the amount of the excess tax in question paid at the source. (C. B. 5, page 248; O. D. 1103.)

Accrual Method Permitted

Since January 8, 1917,[33] when T. D. 2433,[34] (which held

[32] [Former Procedure] Article 193 of Regulations 33, 1918, did not state specifically that "a State tax or any other than a Federal tax" was deductible as interest.

[33] [Former Procedure]

REGULATIONS . . . . Deductions for taxes, however, should be the aggregate of the amounts actually paid, as shown on the cash book of the corporation . . . . (Reg. 33, 1914, Art. 158.)

Reserves for taxes cannot be allowed, as the law specifically provides that only such sums as are paid within the year for taxes shall be deducted. (Reg. 33, 1914, Art. 156.)

[34] See footnote, page 904.

that under the 1916 law, effective as of January 1, 1916, accrued liabilities, such as taxes, would be allowable deductions) was issued, the regulations have permitted the deduction of accruals for all taxes which in themselves are eligible subjects for deduction. Furthermore, the 1921 law plainly states that the term "paid" means "paid or accrued."[35] Consequently, all tax reserves, except those for federal income and excess profits taxes and for special assessments, are deductible. In these years of highly fluctuating profits, proper reserves for taxes are, of course, of great importance.

Accrual of New York State tax.—

RULING. The New York State personal income-tax law, passed May 14, 1919, provides for the imposition of an annual tax upon income, and concludes with the statement that "such tax shall first be levied, collected, and paid in the year 1920, upon and with respect to the taxable income for the calendar year 1919, or for any taxable year ending during the year 1919."

A taxpayer of the state of New York who keeps his accounts upon the accrual basis, may in rendering his federal income tax return for 1919, deduct the accrued tax for his fiscal year ended in 1919, imposed by the New York state personal income tax law, provided such fiscal year ended subsequent to May 14, 1919, the date of passage of the State taxing act. In case his fiscal year ended prior to May 14, the accrued tax would not be deductible in his Federal income tax return for 1919 since it was not a known liability at the time of closing his accounts for such fiscal year.

In the event of judicial interpretation of the New York state personal income tax law which would have the effect of changing the individual's tax liability thereunder it would be necessary for him to file an amended return for Federal income tax purposes. (C. B. 2, page 121; O. D. 505.)

New York State franchise tax deductible in year when liability accrues.—A New York corporation in 1918 revised its 1916 and 1917 state franchise tax returns (the tax liability being for 1917 and 1918). It included in its 1918 returns the reserve set up for additional taxes shown to be due, as well as the tax due for 1919. Although the 1917 law allowed

[35] Section 200 (4).

as a deduction taxes "paid within the year" the Treasury has ruled that the term "paid" includes "accrued." The Treasury held in this case that the true liability existed in the former years and under the accrual method should have been set up in those years; that "liability for the tax does not at all depend upon knowledge of the existence of that liability"; that the deduction for the additional tax be permitted for the former years and disallowed in 1918.[36]

Deductibility of South Carolina income tax.—Taxpayers who keep their books on a cash basis and pay South Carolina income taxes can only deduct those paid during the taxable year. The Treasury "will not undertake to prescribe a method for computing the taxes accrued" during a given taxable year, but the accrual when computed is deductible by those who keep their accounts on an accrual basis. (I-46-591; I. T. 1498.)

Priority of federal taxes.—Taxes due the United States take priority over wage claims. (*In re Morris Kittenplan, bankrupt,* U. S. Dist. Ct., Sou. Dist., N. Y., July 20, 1922; quoted in I-46-596; T. D. 3405.)

Deduction of federal taxes in rate cases.—In *Galveston Electric Co. v. City of Galveston,*[37] the United States Supreme Court held:

Decision. . . . . In calculating whether the 5-cent fare will yield a proper return, it is necessary to deduct from gross revenue the expenses and charges; and all taxes which would be payable if a fair return were earned are appropriate deductions. There is

[36] I-43-558; A. R. R. 1153.
[Former Procedure]
Ruling. The New York State franchise tax, imposed for the privilege of doing business in that State for the fiscal year of the State ending October 31, 1920, is based on 1918 income, but is not due and payable until a later date. A taxpayer making a calendar-year return on an accrual basis may deduct two-twelfths of such tax in his return for 1919 and ten-twelfths in his return for 1920. (C. B. 2, page 112; O. D. 371.)

[37] — U. S. —, 66 L. Ed. —

no difference in this respect between state and Federal taxes, or between income taxes and others. But the fact that it is the Federal corporate income tax for which deduction is made must be taken into consideration in determining what rate of return shall be deemed fair. For, under section 216, the stockholder does not include in the income on which the normal Federal tax is payable dividends received from the corporation. This tax exemption is therefore in effect, part of the return on the investment. . . .

CHAPTER XXXIV

DEDUCTIONS FOR LOSSES

Preceding chapters discuss the deductions for expenses, interest and taxes. The concept of capital gains and losses, first incorporated into the income tax laws in 1921, is treated in Chapter XXII. It remains to discuss the deductions embraced within the comprehensive term "losses." It is desirable to subdivide this subject and to devote separate chapters to the special items, namely, losses due to bad debts, depreciation, obsolescence, depletion and gifts. (Chapters XXXV to XXXIX.) Consequently the subject matter of this chapter is a residuum consisting of the losses due to general and miscellaneous causes, including fluctuation in market values, to disasters and accidents of various kinds, to dishonesty, to faulty judgment, etc., etc.

Until the 1918 act became effective, individuals were subject to a very definite restriction[1] in that losses incurred by them in transactions entered into for profit outside their regu-

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[1] **[Former Procedure]** The provision of the 1913 law relating to the deduction of losses by individuals was as follows:

1913 LAW. Section II (b) . . . . fourth, ... losses actually sustained during the year, incurred in trade or arising from fires, storms or shipwreck, and not compensated for by insurance or otherwise. . . .

The 1916 law introduced the March 1, 1913, basis of valuation and the provision permitting "outside" losses, equal to profits arising from similar transactions, to be deducted.

The 1916 and 1917 laws contained the following:

1916 LAW. Section 5. [Individuals] . . . . (a) . . . . Fourth. Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise: . . . .

Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom.

lar trade or business[2] were deductible only to an amount not exceeding profits arising from similar transactions.

The Treasury formerly restricted the word "profits" to mean only those gains derived from the sale or other disposition of the investment itself.

The Solicitor broadened this definition in a ruling,[3] of which the following is the conclusion:

> RULING. . . . . It is therefore held that all returns—e.g., dividends, rents, interest, surplus from sales, etc.—actually realized within the taxable year from subordinate endeavors entered into for profit are "profits" within the meaning of the fifth deduction, sec. 5 (a), Revenue Act of 1916; and that losses actually sustained within the same taxable year by reason of similar transactions, closed and completed, may be offset to the extent of such realized profits. (C. B. 4, page 163; L. O. 1061.)

The foregoing ruling is retroactive. Taxpayers who had losses in 1917 which were not deducted because of the regulations then in force, may now file claims for refund.

The 1918 law included certain "relief" provisions[4] designed to prevent hardship during the period following the war from possible violent changes in inventory values. The administration of this section by the Treasury restricted the relief to far less than Congress intended when it enacted the 1918 law. The 1921 law contains no provision similar to the inventory loss provision contained in sections 214 (a-12) and 234 (a-14) of the 1918 law, but does contain a "net loss"

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[2] The following ruling is of importance to those whose principal occupation prior to 1918 was trading on margin:

RULING. An individual was daily in touch with his broker during 1917, purchasing and selling stocks exclusively on margin, sustaining losses on some transactions and realizing gains on others, the net result being a loss.

Since he devoted sufficient time and attention to the purchase and sale of stocks to constitute a vocation, and since all purchases and sales were made on margin, thereby indicating that the shares of stock were purchased for resale and not as an investment, it is held that the amount of the loss represents an allowable deduction in computing net income for 1917. (C. B. 4, page 157; Digest A. R. R. 404.)

[3] See also C. B. 5, page 136; A. R. R. 604.

[4] Section 214 (a-12) for individuals, and section 234 (a-14) for corporations.

provision[5] similar in principle to section 204 in the 1918 law, which permits the application of the loss of one year against the net income of a later year. In its application, however, the 1921 "net loss" provision differs materially from the corresponding section of the 1918 law. It is discussed at the end of this chapter, page 965 *et seq.*

The chief problems to be discussed in this chapter are, therefore, the determination of procedure under these special "relief" provisions and the establishment of the standard by which to measure losses due to diminution in values. This second problem is similar to that discussed in Chapter XXI.

Losses Which Are Deductible

In a broad sense there are no limitations, under the 1921 law, upon the right of individuals and corporations to deduct all losses sustained during the taxable year 1921, whether or not incurred in business or trade. There are certain requirements, such as those regarding transactions entered into for profit, "wash sales," etc., but in general all losses may be deducted. The restrictions are fully discussed in the following pages.

Individuals.—

LAW. Section 214. (a) That in computing net income there shall be allowed as deductions: . . . .

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business;

(5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business; but in the case of a nonresident alien individual only if and to the extent that the profit, if such transaction had resulted in a profit, would be taxable under this title. No deduction shall be allowed under this paragraph for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise

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[5] Section 204.

than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed;

(6) Losses sustained during the taxable year of property not connected with the trade or business (but in the case of a nonresident alien individual only property within the United States) if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise. Losses allowed under paragraphs (4), (5), and (6) of this subdivision shall be deducted as of the taxable year in which sustained unless, in order to clearly reflect the income, the loss should, in the opinion of the Commissioner, be accounted for as of a different period. In case of losses arising from destruction of or damage to property, where the property so destroyed or damaged was acquired before March 1, 1913, the deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913; . . . .

Corporations.—

Law. Section 234. (a) . . . . (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;[6] unless, in order to clearly reflect the income, the loss should in the opinion of the Commissioner be accounted for as of a different period. No deduction shall be allowed for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within 30 days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition, unless such claim is made by a dealer in stock or securities and with respect to a trans-

[6] [Former Procedure] The corresponding clause in the 1913 law read:

Law. Section II, G (b) . . . . all losses actually sustained within the year and not compensated by insurance or otherwise.

1916 Law. Section 12. (a) . . . . Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise. . . . .

It should be noted that the 1916 law with reference to corporations reads "actually sustained and charged off." The words "and charged off" did not appear in the section relating to individuals.

The 1918 law omitted the words "and charged off" which formerly appeared, but it is to be assumed that losses will not be allowed unless charged off by items or through reserves.

action made in the ordinary course of its business. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed. In case of losses arising from destruction of or damage to property, where the property so destroyed or damaged was acquired before March 1, 1913, the deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913; . . . .

Regulation. . . . . If (1) a corporation sells its capital assets for less than their cost, and such assets were acquired before March 1, 1913, then if the fair market value on March 1, 1913, less depreciation subsequently sustained and allowable as a deduction is less than the amount realized, no loss is deductible; if (2) such fair market value less depreciation subsequently sustained and allowable as a deduction is greater than the amount realized, but the amount realized exceeds original cost, no loss is deductible; if (3) the amount realized is less than both original cost and the value of March 1, 1913, less depreciation subsequently sustained and allowable as a deduction, the deductible loss is the difference between such amount realized and such cost or March 1, 1913, value, whichever is lower. . . . . (Art. 563.)

The foregoing regulation is confined to the sale of capital assets. When property acquired prior to March 1, 1913, is destroyed or damaged, the loss, to use the language of sections 214 (a-5) and 234 (a-4), "shall be computed upon the basis of its fair market price or value as of March 1, 1913." This applies to both individuals and corporations.

Losses, to be allowed as deductions, must meet the provisions of the law that they have been actually "sustained." This is a reasonable requirement. Most concerns charge off or provide reserves for losses as and when losses occur and the items to be deducted can be taken directly from the books. In the case of individuals who keep no books, more difficulty is experienced.

In discussing the phrase "losses sustained" the regulations state that this condition "must usually be evidenced by closed and completed transactions."[7] This, however, does not preclude the use of inventories for the purpose of ascertaining gains or losses. The privilege of using inventories, long per-

[7] Art. 141.

mitted to business men generally in the case of merchandise, was not extended to dealers in securities until 1918; when it was given this broader application by an opinion of the Attorney General (31 Op. A. G. 301; T. D. 2744) who advised that the Supreme Court in a case (*Doyle v. Mitchell Brothers Company,* 247 U. S. 179) under the 1909 law sanctioned the practice. For a full discussion of inventories the reader is referred to Chapter XIX.

If an individual is engaged in business on his own account or as a partner, and the year's operations result in a net loss, the amount of such loss is an allowable deduction from income from other sources in a tax return.

The Treasury has ruled that a partnership which holds all the stock of a corporation and provides funds to liquidate losses incurred by that corporation, may not deduct such payments as losses of the partnership.

In the case of a partnership which incorporates and commences its operations as a corporation during a taxable year, the loss sustained by the partnership during the portion of the taxable year it was operating cannot be deducted from the income of either the preceding or succeeding taxable year unless the circumstances are such that it could, and did, take advantage of section 229[8] of the 1921 law and elects to be taxed as a corporation for the full taxable year.

Losses may be deducted in year sustained.—The 1921 law[9] permits losses to be deducted in a year other than the one in which the loss was sustained.[10]

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[8] See rulings, C. B. 4, page 54; O. D. 855; and C. B. 5, page 181, A. R. R. 571, under the third paragraph of section 330 of the 1918 law, to which section 229 of the 1921 law is analogous.

[9] Sections 214 (a-6) and 234 (a-4).

[10] **[Former Procedure]** The 1918 and prior laws did not contain this specific provision. Losses, however, were supposed to be deducted in the year when sustained, and the Commissioner had full power to permit amended returns in cases where the discovery was in a later year. The following ruling illustrates the narrow interpretation of the 1918 law.

Ruling. The M Company in 1918 delivered under a bona fide sale goods guaranteed as to quality until July 1, 1919. On inspection of a por-

Regulation. As a general rule losses allowed under paragraphs (4), (5), and (6) of this subdivision shall be deducted as of the taxable year in which sustained. In exceptional circumstances, however, in order to avoid injustice to the taxpayer and to more clearly reflect his income, the Commissioner may permit a loss to be accounted for as of a year other than the one in which sustained. For example, an embezzlement or a shipwreck may occur in 1921 but not become known until 1922 and in such a case income may be more clearly reflected by accounting for the loss as of 1922 rather than of 1921. If a taxpayer desires to account for a loss as of a period other than the one in which actually sustained, he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner, together with a complete statement of the facts upon which he relies. However, in his income tax return he shall deduct the loss only for the taxable year in which actually sustained. Upon the audit of the return the Commissioner will decide whether the case is within the exception provided by the statute; if not within the exception the loss will be allowed only as of the taxable year in which sustained. The allowance of a deduction for a loss in a year other than the one in which sustained is entirely within the discretion of the Commissioner and he will consider exercising this discretion only in exceptional cases. A shrinkage in the value of the taxpayer's stock in trade, as reflected in his inventory, is not such a loss as is contemplated by the provision of the statute authorizing the Commissioner to allow the deduction of a loss for a taxable year other than the one in which sustained. (Art. 146.)

The word "sustained" as used in the law is of doubtful meaning. If used in its ordinary meaning taxpayers should not be permitted to shift losses to periods not affected. If the word is synonymous with "discovered" it is quite proper that losses discovered in one year should not be related back to the period when sustained. The illustrations used in article 146

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tion of the goods in May, 1919, they were found unsuitable, and to save loss resulting from a complete inspection a compromise resale to the M Company was effected at the original purchase price less certain concessions.

Held, that the M Company may not take into its inventory as of December 31, 1918, the goods delivered in that year and that the resale established a basis, in the taxable year 1919, for determining loss. (C. B. 4, page 47; Digest A. R. M. 129.)

It is obvious, in the foregoing ruling, that the loss arose in 1918. The true net income could only be determined by filing an amended return. It is assumed that the loss was an extraordinary one; otherwise it should have been absorbed in 1919.

indicate that the word "sustained" is synonymous with "become known," and therefore with "discovered."

Ruling. . . . . Paragraphs (4), (5), and (6) of subdivision (a) of section 214 of the Revenue Act of 1921 provide for the deduction of certain losses by individuals in the year in which sustained, with the further provision contained in paragraph (6) to the effect that losses allowed under these paragraphs "shall be deducted as of the taxable year in which sustained unless, in order to clearly reflect the income, the loss should, in the opinion of the Commissioner, be accounted for as of a different period." Paragraph (4) of subdivision (a) of section 234 of the Revenue Act of 1921 permits the deductions by corporations in the following language:

Losses sustained during the taxable year and not compensated for by insurance or otherwise; unless, in order to clearly reflect the income, the loss should in the opinion of the Commissioner be accounted for as of a different period.

The above-quoted provisions represent a decided change of policy on the part of the legislature in the enactment of legislation imposing taxes with respect to or on incomes. The Corporation Excise Tax Act of August 5, 1909, provided for the deduction of: "All losses *actually sustained* within the year and not compensated for by insurance or otherwise." (Clause (second) of paragraph Second of section 38.) The Revenue Act of 1913 in the second paragraph of paragraph B of Section II continued the same provision by the allowance of "losses actually sustained during the year." See also paragraphs Fourth and Fifth of subdivision (a) of sections 5 and 6 and paragraph Second of subdivisions (a) and (b) of section 12 of the Revenue Act of 1916, as amended by the Revenue Act of 1917; and paragraphs (4), (5), and (6) of subdivision (a) of section 214 and paragraph (4) of subdivision (a) of Section 234 of the Revenue Act of 1918. In the case of domestic corporations, joint-stock companies or associations, or insurance companies, under the Revenue Act of 1916, not only was it necessary that the loss actually be sustained, but also it had to be charged off in order that the deduction might be taken. (Paragraph Second of subdivision (a) of section 12.)

The Revenue Act of 1921 imposes taxes for the taxable year 1921 and taxable years subsequent thereto. . . . . That it is prospective in its application, except where specific provision is made for retrospective effect, is evident from the other provisions of the Act which expressly are made retrospective. (See second paragraph of paragraph (12) of subdivision (a) of section 214; subparagraph (b) of paragraph (14) of subdivision (a) of section 234; subdivisions (d) and (h) of section 250; section 252; sections 1316, 1318, 1322, and 1331.)

No Act will be construed as retrospective except to the extent that

the statutory language shows the intention "in unequivocable terms." This principle was recognized in Solicitor's Opinion 138 (Bulletin I-20-273) in interpreting the provisions of the sections here under consideration. It was held that the limitations imposed with respect to amortization allowances under paragraph (9) of subdivision (a) and paragraph (8) of subdivision (a), respectively, did not limit the right to claim amortization under the Revenue Act of 1918. See also *Twenty Per Cent Cases* (20 Wall., 179, 187), *Chew Heong v. United States* (112 U. S., 536, 555 to 559). This important principle was confirmed and strictly applied in the recent case of *Shwab, et al. v. Doyle,* decided by the Supreme Court of the United States on May 1, 1922 (Bulletin I-27-395), where the court in interpreting the estate tax provisions of the Revenue Act of 1916, which provide that transfers made "at any time" in contemplation of death were to be included in the value of the gross estate of a decedent dying after the passage of such Act, said:

> The initial admonition is that laws are not to be considered as applying to cases which arose before their passage unless that intention be clearly declared. (1 Kent, 455; *Eidman v. Martinez,* 184 U. S., 575; *White v. United States,* 191 U. S., 545; *Gould v. Gould,* 245 U. S., 151; Story Const., section 1398.) The comment of Story is: "Retrospective laws are, indeed, generally unjust; and, as has been forcibly said, neither accord with sound legislation nor with the fundamental principles of the social compact."

It should be noted that the provisions here in question permit the Commissioner to cause a loss to be taken as of a different period than that in which sustained whenever in his opinion the income of the taxpayer may be more clearly reflected. The Commissioner in the determination of the question is not to be guided by the equities in the case, but is to determine when the loss should be accounted for on principles of law and accounting. Regardless of the fact that a hardship may be imposed on the taxpayer by the action of the Commissioner in compelling the deduction for a loss to be taken in a year other than in which sustained, nevertheless the Commissioner, when he finds that income is not clearly reflected unless such loss is taken as of a different period, is compelled by law to direct that the deduction be taken as of such different period. Furthermore, such action on the part of the Commissioner might well result in the allocation of a loss to a year in which the taxpayer had no taxable income.

The general policy heretofore followed, with certain exceptions, in the taxation of income has been absolutely to close a taxable period as of a certain date. Most of the returns have been filed and audited on this basis. Many cases have been compromised on this theory. To give to the provisions under consideration a retrospective effect would be to reopen the adjustments of taxable years past.

There is a definite policy evident in the decisions of the Supreme

Court against construing any statute, unless the language requires it, so as to disturb figures or conditions which have become fixed or settled. If the word "retroactivity" is to be understood in the narrow sense, then the Supreme Court has not only shown a leaning against retroactivity, but has in addition shown a leaning hostile to any interpretation which assumes a change in any recognized status which has been regarded as settled. The rule is well stated in *United States v. Heth* (3 Cranch., 399, 413), where the court said:

> This rule ought especially to be adhered to, when such a construction will alter the preexisting situation of parties, or will affect or interfere with their antecedent rights, services, and remuneration; which is so obviously improper that nothing ought to uphold and vindicate the interpretation, but the unequivocal and inflexible import of the terms, and the manifest intention of the legislature.

Therefore to construe the language of the provisions here under consideration as having retrospective effect is to violate the fundamental precepts of statutory construction pronounced and constantly adhered to by the Supreme Court in a long line of decisions.

The draftsmen of the Revenue Act of 1921 in the case of amendments to prior Revenue Acts have in each instance specified by reenactment in changed form the provisions of such prior Acts which are amended. The same policy was followed in the Revenue Act of 1918. Not only has specific reference been made in each one of those Acts to amendments of prior Acts, but also sections 1400(b) thereof expressly provide that any sections repealed shall remain in force for the assessment and collection of all taxes which have accrued under the prior Acts. To apply the loss provisions here in question retroactively would be to hold that all prior Revenue Acts are amended thereby and would therefore violate not only the principles upon which the Revenue Act of 1921 was drafted, but also would constitute repeals by implication of those provisions of prior Revenue Acts which are affected. It is a well established principle of law that repeals by implication are not favored. (*Ex parte Crow Dog,* 109 U. S., 556, 557; *Rodgers v. United States,* 185 U. S., 83; *Cope v. Cope,* 137 U. S., 682.)

It has been contended that a failure to construe the provisions here under consideration in a retrospective manner would be to nullify the effect of the sections so far as losses incurred in 1921 are concerned, and that therefore the provisions must of necessity be given retrospective effect. However, such a contention is founded upon the erroneous conception that losses may only be accounted for in a year prior to that in which sustained. If the Commissioner should find that a loss sustained in 1921 properly should be applied against income of a subsequent year, no language in the statute prohibits the accounting therefor in a subsequent year.

Therefore, it is my opinion that (1) the Commissioner may neither

permit nor compel a loss sustained prior to the taxable year 1921 to be accounted for in a previous period; (2) the Commissioner may neither permit nor compel a loss sustained prior to the taxable year 1921 to be accounted for in such taxable year, or any period subsequent thereto; and (3) the Commissioner may neither permit nor compel a loss sustained in the taxable year 1921, or any period subsequent thereto, to be accounted for in a taxable year prior to 1921. (1-38-511; L. O. 1105.)

The foregoing opinion appears to be based on the theory that to apply losses to a period prior to 1921, would in effect repeal the earlier laws, since in such laws losses were deductible only in the year sustained.

The author believes that section 214 (a-6) does not admit any such narrow interpretation. If it does, it was hardly worth while enacting it.

The fact of the matter is that under prior laws the Commissioner had wider discretionary power than he chose to exercise. The provision in the 1921 Act merely declares in specific words what he can and should do. It is another instance of loading up our tax laws with unnecessary details.

Determination and Measurement of Property Losses

The determination and measurement of losses due to a diminution in the value of property involve the same problems of procedure as those which are discussed in detail for the determination and measurement of profits from transactions in property. (See Chapter XXII.) It happens that the important cases which have been decided by the Supreme Court have arisen from additional assessments imposed by revenue officers because of alleged failure to report property gains in full, but the principles established in these decisions apply with equal force to property losses.

Property acquired before March 1, 1913.—The 1916 law in referring to individuals specifically declared "that for the purpose of ascertaining the loss sustained from the sale or

other disposition of property, real, personal and mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amounts of such loss sustained."[11] Using practically the same language, section 10 of the 1916 law established this basis for corporations also. In other words, only losses sustained after March 1, 1913, are deductible. The principle laid down in the 1918 law was the same.[12]

[11] **[Former Procedure]** The 1913 law did not contain this specific provision and for a time there was doubt as to proper procedure. Under the 1913 rulings losses when deductible were prorated over the whole time the property was held, and that part of the loss apportioned to the taxable period appeared in the annual returns. The apportionment was made as of January 1, 1909, in the case of corporations and March 1, 1913, in the case of individuals. This procedure was disputed and was abandoned after the Supreme Court handed down the decisions discussed in detail in Chapter XXII.

[12] **[Former Procedure]** It will be noticed that in the following ruling under the 1918 law no consideration was given to the cost of property acquired prior to March 1, 1913.

RULING. A taxpayer who, prior to March 1, 1913, purchased bonds which had a market value as of March 1, 1913, above par, and which were redeemed at par in 1919 is entitled to deduct, as a loss in 1919, the difference between the market value on March 1, 1913, and the value received in 1919 upon the maturity of the bonds. (C. B. 2, page 132; O. D. 506.)

Under the 1921 law the loss would be allowed as computed in the above ruling, only if the cost prior to March 1, 1913, was equal to the value of the bonds at that date. If the cost was less than March 1, 1913, value the deductible loss would be correspondingly reduced.

An important question to be considered is whether this restriction of the 1921 law is to be deemed to be interpretive of the corresponding loss provisions in previous laws. During 1921 the Supreme Court decided in the cases of *Goodrich v. Edwards* (255 U. S. 527, 41 Sup. Ct. 390, 65 L. Ed. 758), and *Walsh v. Brewster* (255 U. S. 536, 41 Sup. Ct. 392, 65 L. Ed. 762), that an apparent profit representing the difference between value at March 1, 1913, and subsequent sale price was taxable only to the extent that it exceeded original cost of the property. In other words, only actually realized income was intended to be or could be taxed. The Solicitor General, in a brief filed in these cases, contended that if a taxable gain should be limited to the excess of sale price over value at March 1, 1913, or cost, whichever was higher, the allowance for losses should be restricted to the difference between value at March 1, 1913, or cost, whichever was lower.

The court, however, expressed no opinion with respect to the manner in which losses should be computed as this question was not at issue.

Nevertheless, immediately after the decisions in the *Goodrich* and

The 1921 law,[13] however, restricts losses deductible in respect of sales or other disposition of property acquired prior to March 1, 1913, to the lesser of the differences between the sale price and the cost or March 1, 1913, value, respectively.

Shortly stated and eliminating depreciation, obsolescence and depletion (which the law states are to be calculated upon March 1, 1913, value irrespective of prior cost), any appreciation at March 1, 1913, which does not continue until realization cannot be allowed as a deduction. This is fair enough.

A bond cost $700 in 1910; its market value was $900 on March 1, 1913; it is sold for $700 in 1922. There is no allowable deduction for the apparent loss, based on March 1, 1913, value. If sold for $600 there is an allowable loss of $100. If the value of the bond on March 1, 1913, was $600, and it is sold for $500, the allowable loss is only $100, whereas the actual loss as compared with cost is $200. In practice the 1921 law restricts allowable losses to March 1, 1913, values when such values were below cost, and to cost when cost was lower than March 1, 1913, value, under the theory that whatever taxpayers had on March 1, 1913, was their capital. The law works equitably as long as full deduction can be made

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Brewster cases (prior to the passage of the 1921 law), the Treasury amended its regulations pertaining to the determination of profits or losses on sales of property acquired prior to March 1, 1913, embodying therein the method of computation now prescribed by the 1921 law. In the author's opinion these regulations were illegal. The basis of taxing gains must be governed by the sixteenth amendment; there is no inhibition regarding allowable deductions. Congress could allow taxpayers to deduct 150 per cent of losses if it cared to, but it could not increase taxable income 1 per cent. As the 1918 and prior laws permitted deductions on the basis of March 1, 1913, values irrespective of cost, the allowance stands until December 31, 1920, when it was taken away by the 1921 law.

Taxpayers who prior to 1921 were entitled to larger deductions for losses, if based on the language of the 1918 and prior laws, than are allowed under the Treasury's regulations as amended in 1921, should pay under protest any taxes assessed on the latter basis. The question has not been decided in court but it is of sufficient importance to litigate. See the author's comments on L. O. 1105 on page 925.

[13] Section 202 (b).

when any part of such capital is lost. But when deduction is denied because March 1, 1913, value is less than cost and deduction is also denied because appreciation at March 1, 1913, did not continue, the comment "fair enough" applied to the latter contingency is withdrawn because the principle of capital value March 1, 1913, irrespective of cost is departed from.

The measure of deductible losses is not the same as that of taxable gains; but as the computation in case of gains is so nearly like the computation in the case of losses, it is easier to discuss and illustrate the computation in one place. Therefore, the discussion will be found in Chapter XXII.

Property acquired after March 1, 1913.—

REGULATION. For the purpose of ascertaining the gain or loss from the sale or exchange of property, the basis is the cost of such property, or in the case of property which should be included in the inventory, its latest inventory value. . . . . (Art. 1561.)

Determination of value on March 1, 1913.—The process of determining the value at March 1, 1913, of property purchased before that date is fully discussed in Chapter XXII. Suffice it to say here that the question is of enough importance to justify the collection of data which may serve to establish true values as of that date. In the absence of such data the Treasury would probably have assumed (prior to the 1921 law) that the March 1, 1913, value was the same as original cost less depreciation. In view of the new definition of losses deductible upon disposition of property acquired prior to March 1, 1913, which is contained in the 1921 law [section 202 (b)], it is quite conceivable that the taxpayer may be required by the Treasury to prove that the March 1, 1913, value was at least equal to cost of the property before allowing a loss claimed for difference between cost before and sale price after March 1, 1913.

The 1921 law provides that exchanges and reorganizations are closed transactions (a) when property received has a readily realizable market value, *and* (not "or") (b) the prop-

erty received is of a different nature than that parted with.[14] These requirements are fully discussed in Chapter XXI, and need not be repeated. Shortly stated, losses cannot be deducted unless there is a closed transaction.[15]

Establishment of loss by inventory method.—Inventories are now prescribed as "necessary in every case in which the production, purchase or sale of merchandise is an income-producing factor."[16] Prior to 1917 the use of inventories was permitted for the purpose of establishing gains or losses only in the case of merchants and manufacturers. For a full discussion of this subject the reader is referred to Chapter XIX. Permission to use the inventory method has been extended to dealers in securities. Valuation at "cost or market whichever is the lower" is permitted.[17] Also, dealers in securities may now, if they elect, inventory at "market" without reference to cost.[18]

Inventoried shrinkage in securities deductible only by dealers.—Stocks and bonds owned by others than dealers may not be revalued periodically and losses may not be charged off by the inventory method. Neither can amounts invested in

[14] **[Former Procedure]** The 1918 law, section 202 (b), provided that "when property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any."

[15] For discussion of closed transactions see Chapter XXI and *Income Tax Procedure*, 1921, page 793.

[16] See page 474.

[17] **[Former Procedure]** Before December 19, 1917, shrinkage in the value of securities was not allowed as a deduction even when they were the stock-in-trade of a dealer. This position is illustrated by the following Treasury decisions.

Regulations. This ruling, in so far as it relates to depreciation . . . . is not to be construed as recognizing any gain or loss due to fluctuations in the market value or arbitrary changes in the book value of securities and like assets, the gain or loss with respect to which will be determined only when such assets mature, or are sold or disposed of —that is, when there is a completed, a closed, transaction. (T. D. 2077, November 21, 1914.)

Losses of this character are only ascertainable when the securities mature, are disposed of, or cancelled. (T. D. 2152, February 12, 1915.)

[18] Art. 1585.

foreign money be so treated when merely due to a fall in exchange.[19] Excepting when investments become worthless,[20] they must mature or be sold to establish a loss.

REGULATION. A person possessing stock of a corporation can not deduct from gross income any amount claimed as a loss merely on account of shrinkage in value of such stock through fluctuation of the market or otherwise. The loss allowable in such cases is that actually suffered when the stock is disposed of. . . . . (Art. 144.)

WHEN DEDUCTION FOR SHRINKAGE MAY NOT BE CLAIMED BY HOLDERS OF LIFE OR TERMINABLE INTERESTS.—

REGULATION. . . . . No deduction shall be allowed in the case of a life or terminable interest acquired by gift, bequest, or inheritance, where the estate or trust is entitled to a deduction under the statute but there is no reduction of the income of the life or terminable interest. For example, an estate or a trust in a certain State sells securities at a loss; if, under the laws of that State, the beneficiary suffers no actual loss, then even though the estate or trust is permitted to deduct such loss in making its return, the beneficiary whose income has not been diminished thereby is not entitled to a deduction on account of such loss but must include in his return the full amount distributed or distributable. . . . . (Art. 295.)

Section 215 (b)[21] of the 1921 law, on which the above article is based, enacted into law the procedure laid down by the Treasury in article 347 of Regulations 45. The criticism has been expressed that article 347 gave effect to an interpretation for which there was little or no warrant in the 1918 law itself.[22] The Treasury's point, however, may have been well taken. If the life beneficiary actually receives certain income from the estate, he is certainly receiving "income derived from any source whatever" (section 213 of 1918 Act), and it is rather difficult to see why he should have a deduction for losses which do not fall on him but on the remainderman. On the other hand, it might possibly be argued (though the argument does not seem to be very sound) that, despite the

[19] C. B. 4, page 155; O. D. 764.
[20] See page 933.
[21] See Chapter XLII for text.
[22] This question was discussed at some length in *Income Tax Procedure*, 1921, pages 1040-1046.

fact that the life-tenant is supposed to get only the income of the estate, he is—if sound accounting principles be applied —actually receiving the net income of the estate *and* a payment of principal, this being due to the effect of estate tax law by which capital losses are not permitted to reduce income.

Loss on bonds sold by bank at discount.—

RULING. Where certain banks entered into an agreement with the State authorities and with a firm of brokers, that the banks would purchase from the State at par certain bonds and the brokers would buy the bonds from the banks at a discount and the State officials would deposit the funds derived from the sale of the bonds in the banks and leave such funds there as long as possible, drawing interest at the regular rate of 2 per cent, the loss incurred by the banks on the sale of the bonds to the brokers may be deducted in computing income subject to tax. (C. B. I-1, page 142; Digest I. T. 1247.)

German investments—when determined worthless.—When securities bought in Germany for 300,000 marks (value at time of purchase $9,000) are sold for 500,000 marks (value at time of sale $5,000), the loss of $4,000 is deductible from income.[23]

RULING. Receipt is acknowledged of your letter of the 10th inst., in which you state an American corporation owns some German investments. You desire to be advised whether or not this corporation can charge off such investments as an actual loss and deduct the same in preparing its return of annual net income with the understanding that any amounts subsequently received will be credited to income in subsequent years.

In reply you are informed that the tax law makes an allowance for a deduction from gross income of all losses actually sustained by a corporation during the year for which the return is made. However, in the case you mention it does not appear that a loss which is definitely known has been sustained from a closed and completed transaction. Therefore, it is necessary to hold that the American corporation in question can not deduct an amount representing a part or the whole of the German investments inasmuch as at best this deduction would be merely estimated and not a loss from a closed and completed transaction. (Letter to Lybrand, Ross Bros. & Montgomery, New York, signed by Deputy Commissioner L. F. Speer, and dated September 18, 1918.)

[23] C. B. 4, page 234; O. D. 809.

Russian investments.—

Ruling. Because of disturbed political conditions in Russia there is little hope that bonds of the Imperial Internal Russian 4 per cent loan of 1894 will be redeemed. A holder of such bonds which were purchased in 1916, who was unsuccessful in finding a market for them during the year 1919, is entitled to a deduction from his gross income for that year to the extent of the amount actually paid for them, provided, however, that such amount is charged off the taxpayer's accounts for the year 1919 and a corresponding reduction made in his surplus account. (C. B. 3, page 167; O. D. 748.)

Losses on Liberty bonds distributed in dividends.—The recipient of a dividend paid in Liberty bonds or other securities should return the dividend for taxation at the market value of the securities at the time of their receipt.[24] The corporation paying the dividend should charge to dividend account the market value of the securities distributed. If the market value at time of distribution is less than the price paid for the securities, the difference should be charged off as a loss.

The Treasury held in an earlier ruling that such a loss is not an allowable deduction,[25] on the ground that a transaction conducted by a corporation with its stockholders is not of a character to affect the amount of its net income. This argument was inconsistent with the Treasury's rulings, to the effect that the corporate entity must be disregarded when used to avoid the payment of tax on income. The inconsistency was evidently recognized, since in a later ruling[26] the Treasury allowed as a deduction the net difference between the market value at March 1, 1913, of securities and their value when distributed as a dividend in 1917. The mere technicality that the dividends were not declared in terms of market value cannot prevent corporations from claiming the loss.

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[24] See article 1544, page 743.
[25] C. B. 1, page 28; O. D. 262.
[26] C. B. 4, page 27; A. R. R. 435.

When deduction may be claimed for shrinkage.—

REGULATION. . . . . However, if stock of a corporation becomes worthless, its cost or other basis determined under section 202 may be deducted by the owner in the taxable year in which the stock became worthless, provided a satisfactory showing of its worthlessness be made, as in the case of bad debts. Where banks or other corporations which are subject to supervision by Federal authorities (or by State authorities maintaining substantially equivalent standards) in obedience to the specific orders or general policy of such supervisory officers charge off stock as worthless or write it down to a nominal value, such stock shall, in the absence of affirmative evidence clearly establishing the contrary, be presumed for income tax purposes to be worthless.[27] . . . . (Art. 144.)

Heretofore when a taxpayer has had worthless stocks he has been compelled to go through the farce of selling them to someone for a dollar before the loss could be deducted.

RULING. Treasury Decision 3261 (Bulletin I-1, p. 12) merely prescribes what constitutes acceptable evidence as to the worthlessness of stock in the case of banks and other corporations subject to supervision, and does not in any sense alter or amend the ruling that the loss is deductible only when the stock becomes worthless.

The provision that the loss is deductible if the stock is written down to a nominal value only applies, of course, in case the stock is actually worthless; that is, it deals merely with the charging off of the stock, and does not restrict in any sense the provisions that the loss is deductible only if and when the stock becomes worthless. A taxpayer owning stock which becomes worthless is, therefore, not precluded from deducting his loss merely because, instead of charging the stock off completely, he writes it down to a nominal amount; that is, an amount which is nominal considering the cost of the stock. (C. B. I-1, page 147; Digest I. T. 1282.)

Losses on sales of securities.—There has never been any question as to the deductibility of losses sustained by corporations arising out of the *sales* of securities (treasury assets) at less than cost, because there were no limitations in the sections of the laws relating to corporations such as formerly applied to individuals. But a loss must be actually "sustained"

[27] [Former Procedure] Reg. 45 (1918), Art. 144, specifically excluded "dealers in securities" from the provisions of that article. The omission in the present article has no significance in that "dealers in securities" are allowed to inventory their securities on hand. See page 929.

to be an allowable deduction. It must have more evidence than a book entry to support it.

When sales of assets are made to stockholders at less than book value the burden of proof is on the corporation to show that the sales prices are fair and reasonable. Otherwise it can hardly be held that an actual loss has been sustained.

If sales to stockholders are made at less than book value, and also at less than market or fair value, the stockholders have, in effect, made a "bargain" purchase. If sales by the individuals are made subsequently at prices higher than cost the resulting profit no doubt will be reported, but such procedure would not offset the fictitious loss created on the corporation's books if the corporation had taxable income subject to the excess profits tax. Corporations selling securities to their own stockholders at less than fair or market value cannot expect to secure credit for any book loss created thereby.

If, however, the corporation is not permitted to deduct the loss, the stockholders cannot be charged with having made a bargain purchase, and upon any resale they would be taxable only upon the price realized in excess of the book value of the securities as shown by the books of the corporation.

The basis for determining the loss when securities of the same issue, which were bought at different prices, are sold at a loss is given in Chapter XXII.

Under the 1921 law the sale by one corporation to another corporation controlled by the same interests may not result in any allowable loss. Section 240 (d) provides that the Commissioner may consolidate the returns of corporations owned by the same interests.[28]

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[28] **[Former Procedure]** The following ruling was made under the 1917 law, in which no specific provision for consolidated returns appears:

Ruling. The fact that a new corporation organized for the purpose of taking over a branch of the business of an existing corporation has the same stockholders as the existing corporation does not, in the absence of fraud, effect a merger of the two corporations nor so destroy their separate identities as to prevent the realization of gain or loss from the sale of stocks and bonds held by the existing corporation to the new corporation.

Contributions by stockholders.—The stockholders of a corporation "on the verge of bankruptcy" in 1920 surrendered 70 per cent of their stock to the creditors. The owner of 100 shares had paid $10,000 for it; he retained 30 shares. The Treasury held that the 30 shares must be carried as worth $10,000 "until the stock now held is sold or otherwise disposed of, or becomes worthless, in whole or in part."[29] The ruling fails to pass on the allowable deduction. In view of the imminence of bankruptcy, it would seem that the $10,000 had become worthless "in part" at least, to the extent of $7,000.

ASSESSMENTS ON STOCK.—

REGULATION. . . . . An assessment paid by a stockholder of a national bank on account of his statutory liability . . . . may in certain cases represent a loss. . . . . (Art. 293.)

Application of tax-free distributions in computing losses.—

LAW. Section 201. . . . . (b) . . . . **If any such tax-free distribution has been made the distributee shall not be allowed as a deduc-**

Law Opinion 1035, revised, overruled in part. (C. B. 4, page 168; Digest L. O. 1062.)

The facts, in the foregoing case, stated in the detailed opinion, were that:

Subsequent to the passage of the Revenue Act of 1917, upon advice of counsel that it could not include in its invested capital, as defined by that Act, the large amount invested by it in stocks of other corporations, in pursuance of a plan previously considered, the stockholders of the company organized a corporation known as the N Company to purchase the securities of the M Company and engage in the business of buying and selling securities. The N Company had an authorized capital stock of 12½x dollars all paid in in cash at the time of its organization. In November, 1917, the M Company transferred and delivered the securities then owned by it of an aggregate market value of 1289x dollars to the N Company at the market value plus accrued interest amounting to 7x dollars, the purchase price being paid 12x dollars in cash and the balance in collateral promissory notes secured by the pledge of the same securities. The cost of these securities to the M Company or their value on March 1, 1913, was 1764x dollars and the M Company in its return for the year 1917 claimed a deduction for a loss of 475x dollars.

In an earlier decision [C. B. 3, page 160; L. O. 1035 (Rev.)], the Solicitor held the sale to be "a sham and a subterfuge to evade taxation." Corporate entities were disregarded in the earlier decision; in the later decision full effect is given to the corporate entity theory.

[29] C. B. I-1, page 194; I. T. 1168. See also C. B. I-1, page 195; I. T. 1288.

tion from gross income any loss sustained from the sale or other disposition of his stock or shares unless, and then only to the extent that, the basis provided in Section 202 exceeds the sum of (1) the amount realized from the sale or other disposition of such stock or shares, and (2) the aggregate amount of such distributions received by him thereon. . . . .

Regulation. . . . . A distribution made by a corporation out of earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913,[30] is exempt from tax, even if in excess of the cost or other basis provided in articles 1561-1563 and 1568, of the stock on which declared. However, where any tax-free distribution out of earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, has been made, the distributee can not deduct any loss from the sale or other disposition of the stock unless and then only to the extent that the cost, or other basis, exceeds the sum of (1) the amount realized from the sale or other disposition of the stock, and (2) the aggregate amount of such distributions received by him thereon.

Example.—A purchased certain stock subsequent to March 1, 1913, for $10,000 and received in 1921 a distribution thereon of $2,000, paid out of the earnings or profits of the corporation accumulated prior to March 1, 1913. This distribution does not constitute taxable income to A. If A subsequently sells the stock for $6,000 a deductible loss of $2,000 is sustained. If he sells the stock for $12,000, a taxable gain of $2,000 is realized. No gain or loss is recognized if he sells the stock for an amount ranging between $8,000 and $10,000 (Art. 1543.)

In the foregoing example the question of whether cost or value at March 1, 1913, is to be used as a basis for computing gain or loss is not considered since the stock was acquired after March 1, 1913.

Assume A owns 100 shares of stock purchased in 1910 for $10,000, and at March 1, 1913, the value of such stock was $15,000. In 1918 and 1919, A receives $2,000, "dividends" paid out of earnings accumulated prior to March 1, 1913, or out of appreciation accrued at that date.[31] In 1921, A sells his 100 shares for $7,000. Under section 202 (b-2),[32]

[30] See pages 718-722.

[31] For discussion of appreciation realized through depletion charges, see Chapter XXXVIII.

[32] See page 564.

A determines his loss by deducting the sales price ($7,000) from the cost ($10,000), since the March 1, 1913, value $15,000 is higher than cost. The resulting loss is $3,000. But "the amount realized from the sale" ($7,000) plus the tax-free "dividends" ($2,000), or a total of $9,000, when compared with the cost ($10,000), results in a loss of only $1,000. In other words, the loss which would ordinarily be deductible ($3,000) is reduced by the aggregate amount of the tax-free "dividends" ($2,000).

In case a gain is realized, the tax-free distributions are ignored. If in the illustration above the 100 shares had been sold in 1921 for $20,000, the profit would be $5,000 (excess of sales price, $20,000, over March 1, 1913, value $15,000).

Stated in tabular form we have:

CASE "A"

(a) Cost of Stock before 1913	(b) Value of Stock March 1, 1913	(c) Tax-free "Dividends"	(d) Sale Price	(e) Loss under Section 202 (a—d)	(f) Loss to be Reported in Tax Return[33] (a—c—d)
$10,000	$15,000	$2,000	$7,000	$3,000	$1,000

CASE "B"

(a) Cost of Stock before 1913	(b) Value of Stock March 1, 1913	(c) Tax-free "Dividends"	(d) Sale Price	(e) Gain under Section 202 (d—b)	(f) Gain to be Reported in Tax Return same as (e)
$10,000	$15,000	$2,000	$20,000	$5,000	$5,000

It is well to note that if the sales price falls between the *reduced* basis (cost, or market value March 1, 1913, minus tax-free dividends) and said basis before reduction by the amount of tax-free dividends, no gain or loss is recognized. For example, if in case A above, the sales price had been $9,000, there would be no loss. In case B above, if the sales price had been $14,000, there would be no gain because the sales price lies between cost ($10,000) and value March 1, 1913,

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[33] Under section 201 (b).

($15,000). In the latter case the tax-free "dividend" ($2,000) is ignored.[34]

"Wash sales" for the purpose of establishing losses.—So long as accrued losses (shrinkage in values of securities) are not deductible until "evidenced by closed transactions" it is only natural that attempts should be made to convert paper losses into actual losses in order to obtain the benefit of the deduction. If securities are sold at a loss to a *bona fide* buyer, with no agreement to repurchase nor any similar agreement, the loss has been legally established and becomes an allowable deduction. Sales through a stock exchange are actual and completed transactions because the seller has no control over the buyer. Subsequent repurchase of a similar amount of securities does not affect the *bona fides* of the transaction because the buyer takes a chance of having to pay a higher price and the transaction is in fact a new deal.[35]

Nevertheless the following section of the 1921 law must be considered:

LAW. Section 214. (a) . . . . (5) . . . . No deduction shall be allowed under this paragraph for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within thirty days before or after the date of such sale or other disposition the tax-

[34] For computation of gain or loss from liquidating dividends, see page 739 *et seq.*

[35] [Former Procedure] Prior to the passage of the 1921 law, "sales to establish losses" were not in most cases questioned by the Treasury, as is evidenced by the following ruling issued in 1919:

RULING. If a taxpayer makes an actual bona fide sale of securities at a loss in 1918, the loss is deductible even though the taxpayer repurchases the securities in the succeeding year at the same price for which they were sold. However, the burden of proof will be on the taxpayer to show that the sale was not fictitious. (C. B. 1, page 124; O. D. 103.)

In another case a taxpayer offered stock at public auction, with instructions to buy it in for his account if there were no other bidders. It was bought in for his account at a nominal price. The Treasury held that "the facts failed to disclose an actual sale of the stock in question. . . . . A person cannot be both seller and purchaser in the same transaction." (C. B. I-1, page 141; I. T. 1181.) Under the 1921 law such a loss would also be disallowed because of the repurchase "within 30 days."

payer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed; . . . .

The following regulation outlines the procedure under the 1921 law:

Regulation. An individual, other than one in the trade or business of buying and selling securities, or a corporation, other than a dealer in stocks or securities, can not deduct any loss claimed to have been sustained from the sale or other disposition of stock or securities made after November 23, 1921, if within 30 days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed. . . . . This provision is designed to prevent a taxpayer who owns securities, other than one in the trade or business of buying and selling securities, from selling and immediately repurchasing them or from purchasing substantially identical property and immediately selling the original securities and claiming as a deduction in computing net income the so-called "loss" sustained therefrom. Gain or loss, however, is realized in the case of the "short sale." Under this section a taxpayer owning a hundred shares of stock in the X company, who purchases another hundred shares of stock in the X company and within 30 days thereafter sells the first purchased stock of the X company, can not deduct in computing net income any loss claimed to have been sustained from the transaction; if he sells the entire 200 shares of stock, a gain or loss from both transactions is realized at that time; and if he sells the stock of the X company included within the second purchase a gain or loss is realized thereby. (Art. 147.)

Ruling. Second 4¼ per cent Liberty bonds and fourth 4¼ per cent Liberty bonds are not substantially identical property within the meaning of section 214(a)5.

"Substantially identical property" does not include all of one kind or class of property, the meaning given to "property of a like kind" under section 202(c)1, Revenue Act of 1921, but is limited to property which is the same in all important particulars. Important features of securities are their earning power or interest rate; value of assets, tangible and intangible, or security; and conditions of re-

tirement, or in the case of bonds, the date of maturity. (C. B. I-1, page 151; Digest I. T. 1365.)

The 1921 law and the regulations are fair enough and will not result in any great hardships.

It is to be noted that sales made on or prior to November 23, 1921, (the date the 1921 law was passed) are not affected by the above provision. The status of such sales is the same as it would have been under previous laws.[36]

The foregoing section applies to individuals but there is a similar provision applicable to corporations[37] which includes the statement, however, that the loss is to be allowed if "such claim is made by a dealer in stock or securities, and with respect to a transaction made in the ordinary course of its business." The section quoted above,[38] applicable to individuals, does not contain a similar statement because individuals or partnerships recognized as dealers in securities would not claim deductions for their losses on securities, under section 214 (a-5), but under section 214 (a-4), which latter section allows a deduction for "losses . . . . incurred in trade or business." Section 214 (a-4) does not contain the thirty-day limitation on re-acquirement of securities sold at a loss.

Where deductions are not allowed under section 214 (a-5) or 234 (a-4), the securities acquired are deemed to have taken the place of the securities sold. In the case of subsequent sale of the acquired securities the cost or March 1, 1913, value, of the original securities would form the basis of loss sustained or gain derived therefrom. [See section 202 (d-3) of the law, and article 1567.]

Section 214 (a-5), quoted on page 917, applies only to losses and not to gains from sale of securities.[39]

Losses arising from the sale of property acquired by gift.—Prior to 1921, deductible losses arising from the sale of prop-

[36] C. B. I-1, page 150; I. T. 1240.
[37] Section 234 (a-4).
[38] Section 214 (a-5).
[39] C. B. I-1, page 149; I. T. 1239.

erty by donees were comparatively easy to determine. Losses consisted of the difference between the value of gifts when received and the proceeds of sales. Under the 1921 law the basis of loss[40] is "the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift."

In discussing gains realized by donees,[41] the difficulty of securing information was mentioned. It will no doubt be more difficult to secure data from donors regarding gifts when values have declined. In such cases donees will fail to receive the benefit of deductions to which they are entitled.

A loss may be denied by the Treasury where the conduct of the recipient furnishes evidence that the property was not acquired for the purpose of profit.[42]

The provision of the law is of doubtful legality and expediency but its evolution will be interesting.

Congress may have invented a new method of reducing taxes. A taxpayer not subject to tax, owning investment property greatly depreciated in value, may make a gift of such property to another taxpayer subject to high surtax rates and the latter may sell the property and claim a very large loss.

Losses in speculation.—If a taxpayer buys "futures," hoping to sell the contracts at a profit, and instead is compelled to sell at a loss and claims credit for the loss in his income tax return, it becomes specifically an unlimited deduction under the 1921 law, and would also have become so under the 1918 law.[43] Under the 1913 law the loss would not have been deductible. Under the 1916 and 1917 laws the loss would have been deductible to an amount of profits derived from similar transactions.

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[40] Section 202 (a-2).
[41] See page 618.
[42] See C. B. 1, page 122; T. B. R. 35, page 945.
[43] [Former Procedure]

DECISION. Losses incurred by a member of a partnership, engaged in manufacturing jute bags and bagging, through his individual dealings on a cotton exchange are not incurred in trade within the meaning of section

Losses on sale of capital assets.—The chapters on appreciation in values (XXII) and sales and exchanges (XXI) deal with the principles which underlie the deductibility of losses as well as the taxability of profits. It is therefore unnecessary to repeat under this subject heading the comments which are found in the chapters mentioned.

Losses must be sustained bona fide.—The Treasury has ruled that when property acquired by gift is transferred or ostensibly sold for considerably less than its actual value, the difference between actual value and the sales price is a gift and is not an allowable loss to the donor.[44] The ruling is sound. Deductions for losses should be those sustained *bona fide*.

Losses due to scrapping of buildings and machinery deductible.—

Regulation. Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery, equipment, etc., incident to renewals and replacements will be deductible from gross income in a sum representing the difference between the cost of such property demolished or scrapped and the amount of depreciation sustained with respect to the property prior to its demolition or scrapping, and allowable as a deduction in computing net income. . . . . (Art. 142.)

Ruling. When property is discarded and salvaged, the depreciation allowance plus the salvage value may slightly exceed or fall slightly below the cost of the property. In the case of a gain over cost this must be treated as income. If the depreciation allowance plus salvage falls below the cost, the difference may be treated as a loss.

The fact that a taxpayer in past years neglected to allow for sufficient depreciation does not make the resulting discrepancy between the book values of equipment and its salvage value at the time it is retired from service deductible as a loss within the intent of Section

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II, subdivision B of the act of 1913, and therefore are not deductible in computing net taxable income under that act. (*Mente v. Eisner,* 266 Fed. 161, 11 A. L. R. 496. Petition for writ of certiorari was denied October 11, 1920, 254 U. S. 635, 65 L. Ed. 449, 41 Sup. Ct. 8. The quotation is from T. D. 3029.)

[44] C. B. 4, page 45; O. D. 847.

II G(b) second, act of October 3, 1913. In such cases the taxpayer may avail himself of a larger deduction for depreciation by submitting amended returns for previous years, and showing that the previous depreciation rate was not reasonable. . . . . (C. B. 1, page 120; Digest S. 1217.)

Depreciation is an allowable deduction but not a compulsory deduction. If insufficient or no depreciation has been charged over a term of years, it is true that a strictly accurate method of accounting would call for the reopening of accounts for the entire past period, the restatement thereof and the preparation of revised profit and loss accounts. But business could not be conducted that way. Neither can it be expected that tax returns for past periods can be amended every time an item applicable to prior years turns up. The foregoing regulation if strictly construed would call for amended returns for as many years as elapsed during the time when insufficient or no depreciation was charged. If the amount involved is substantial, amended returns must and should be prepared. The regulation, however, can hardly be intended to control the usual adjustments which are always necessary in dealing with depreciation, because exact rates will never be available. In most cases it will be sufficient to charge off the entire book loss during the period in which it is ascertained. The law itself, as well as article 111 of Regulations 62, seems to permit this.

Cost of demolishing old building on new site not deductible as loss.—

Regulation. . . . . When a taxpayer buys real estate upon which is located a building which he proceeds to raze with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building, and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building. (Art. 142.)

This regulation is sound because all so-called expenses in construction enterprises are proper capital expenditures, and

the cost of demolition of an old building is a capital charge. This rests on the principle that there can be no operating loss or expense in a new business until after the business commences to operate.

Ruling. Improved real estate consisting of several frame dwellings was purchased primarily for the purpose of enlarging a business plant. No deductible loss was sustained by reason of the sale of the buildings apart from the land for their salvage value, notwithstanding the fact that the taxpayer would have paid considerably less for the property had it been aware at the time of purchase of a fire regulation, then in effect, which prohibited the moving of the buildings. The value of the land exclusive of the buildings is presumed to be equal to the purchase price of the land and buildings less the amount received as salvage. (C. B. 5, page 141; Digest O. D. 1031.)

The following ruling is unsound because the principle laid down in article 142 does not apply. When taxpayers find that property is obsolete or inadequate, the loss is fully deductible, not as a loss, but as obsolescence.[45]

Ruling. A taxpayer sustains no deductible loss in the demolition of 80 per cent of his building for the purpose of reconstruction. The amount expended is an investment of capital and should be considered as a part of the cost of reconstruction. (C. B. 4, page 164; O. D. 773.)

Business Losses

The language of the statute is so broad in dealing with business losses that the problems of procedure are few and simple.

Losses incurred in transactions entered into for profit.—Under section 214 (a-5) of the 1921 law an individual may deduct all net losses "if incurred in any transaction entered into for profit, though not connected with the trade or business." The chief factors which decide the deductibility of this class of losses are:

1. The loss must be an actual one. It must be more

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[45] See Art. 143.

than conjectural. Generally speaking, the taxpayer must be "out of pocket" the amount of the loss.

2. The loss must have been sustained during the taxable year.

3. The transaction must have been undertaken for profit. If a man buys an automobile for pleasure purposes at one price and sells it for a lower price, the loss sustained is not deductible. If a man buys or builds a residence for his own occupancy and sells it for less than cost, the Treasury holds that the loss is not deductible.[46]

4. It must be a net loss. Any insurance, etc., received must be credited against the gross loss sustained.

RULINGS. Section 214 (a) 5, Revenue Act of 1918, does not contemplate that a distinction shall be made between an investment in property or securities with the object of deriving an income from the capital employed, and an investment which is made for the purpose of realizing a profit on the resale of the property or securities purchased. (C. B. 1, page 124; O. D. 138.)

A loss sustained from the sale of property acquired by gift, bequest, devise, or descent (whenever property so acquired is as a matter of fact acquired for purposes of profit) is a deductible loss from gross income. Ordinary investment property so acquired is to be treated as having been acquired for purposes of profit unless the conduct of the recipient furnishes evidence to the contrary. (C. B. 1, page 122; Digest T. B. R. 35.)

If a taxpayer purchases royalty interests in tracts of oil land (not including title to the land itself) and such interests prove worthless, as evidenced by all wells drilled proving dry or failing after producing very small quantities of oil, the loss sustained is an allowable deduction from gross income. (C. B. 2, page 128; O. D. 375.)

A taxpayer who takes an option to purchase a piece of real property, but fails to complete the purchase, thereby losing the amount paid on the option, may take as a deductible loss any part of the amount so paid not compensated by insurance or otherwise. (C. B. I-1, page 142; Digest I. T. 1230.)

Losses arising from cancellation of contracts.—

RULING. . . . . The question under consideration is whether a sum paid in 1919 by a company to be relieved from a contract for de-

[46] Art. 141.

livery of goods in 1918 and 1919 is deductible in 1918, the year in which the matter was negotiated, though the final agreement and adjustment and payment was not made until 1919. . . . .

In the present case the amount to be paid for the cancellation of the contract was not determined nor paid until 1919. The loss was not a *closed* and *completed* transaction until that time. Negotiations were entered into in 1918, but the final outcome of the same or the amount to be paid as liquidated damages, was not, and from the nature of things would not be, known until the final agreement and adjustment had been made. . . . .

It is held that where a corporation pays liquidated damages in 1919 to be relieved from the terms of a contract which called for the delivery of goods in 1918 and 1919, the loss so incurred is deductible from gross income for the year 1919 rather than 1918. (C. B. 1, page 217; S. 983.)

The foregoing ruling may be sound when applied to the specific facts in the case under review. The general principles laid down are, however, subject to criticism.

In the case of government contracts canceled prior to but unsettled at December 31, 1918, the Treasury at one time took the position in Regulations 45 that upon settlement thereof after 1918 any additional profit must be accounted for in 1918.[47]

In a later ruling it is held that amended returns may be made to adjust items applicable to prior years.[48]

Losses on non-depreciable assets acquired prior to March 1, 1913.—

RULING. Prior to March 1, 1913, the taxpayer assigned all his rights in a copyrighted book to a publishing company, which agreed to publish the book at its own expense and to pay a royalty on the retail selling price of all copies sold. The agreement further provides that if the publishers can not sell the books at cost to them the publishers shall have the privilege of terminating the agreement without paying the author any royalties on any of the copies thereafter sold.

The taxpayer's right to receive the royalties is not subject to depreciation. Should the contract be terminated as above or the right be determined to be worthless, the amount by which the cost or March 1, 1913, value of the right, whichever is lower, exceeds the royalties

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[47] For adjustment of government contracts, see page 467 *et seq.*

[48] C. B. 5, page 131.; A. R. R. 685.

received or accrued since March 1, 1913, will be deductible as a loss. . . . . (C. B. I-1, page 146; Digest I. T. 1352.)

The principle in the foregoing ruling applies to any non-depreciable asset acquired prior to March 1, 1913.

Losses sustained by individuals.—Losses deductible by an individual are described in the law by three phrases: first, losses incurred in trade or business; second, net losses sustained in transactions entered into for profit, though not connected with trade or business; third, net losses sustained in transactions not connected with trade or business if arising from fire, storm, shipwreck or other casualty or from theft.

In all the foregoing it will be noted that the losses must be "net" losses—that is, the actual money loss sustained by the taxpayer. If reimbursed in whole or in part by insurance or compensated in any other way, the loss is not a net loss except as to any part not reimbursed.

This is not intended to mean that the taxpayer cannot deduct a loss based upon a revaluation as of March 1, 1913. This point is covered on page 564. Neither does it apply where the beneficiary of an estate subsequently sells stocks, bonds or any kind of property at a price less than the fair market or appraised price at the time when the property was received.[49] The measure of deduction is based entirely upon the valuation at the time when the property changed hands, and the loss is just as much deductible by the beneficiary of the estate as if the beneficiary had paid in cash the amount of the appraised value. This, of course, is subject to a general rule that depreciation must be always taken into consideration, but the rule depends on whether depreciation is an allowable deduction or not.[50]

Furthermore, the loss must be a property loss. Losses from casualties, thefts and other causes produce consequential losses which are in addition to and grow out of property

[49] Regarding losses on gifts, see page 940.
[50] See page 567.

losses, but the words "arising from" cannot be construed broadly enough to include anything but the loss of property itself.

A taxpayer not in business on his own account sent an agent to Europe to establish an export business. The report was unfavorable and the idea was abandoned. Held that the expenditure was a deductible loss—not a business expense. (I-47-603; I. T. 1505.)

Rulings. An amount paid by a former director of a bank in compromise of a suit against him by a receiver for dereliction and neglect of duty as such director is deductible as a loss within the meaning of section 214 (a) of the Revenue Act of 1918. (C. B. 5, page 139; Digest O. D. 1091.)

Damages paid by a taxpayer engaged in the real estate business pursuant to a judgment against him for misrepresentation of land sold are deductible from gross income under section 214 (a) 4 of the Revenue Act of 1918. (C. B. 5, page 135; Digest O. D. 978.)

Loss on sale of individual's residence.—

Regulation. . . . . A loss on the sale of residential property is not deductible unless the property was purchased or constructed by the taxpayer with a view to its subsequent sale for pecuniary profit. . . . . (Art. 141.)

If a taxpayer buys or builds or inherits a house (which he occupies as a residence), and sells it for less than cost, or value March 1, 1913, it cannot be claimed that the loss has been sustained in trade or business. Profits from any source are taxable, but losses are deductible only to the extent mentioned. If, however, the house is destroyed by casualty and not compensated by insurance, the actual loss is deductible since it happens to fall within a specific provision of the law.

Rulings. . . . . The intent in purchasing or constructing the property is a question of fact determinable in each case by evidence which should be submitted with the return. (C. B. 1, page 117; O. 780.)

A loss resulting from the sale of a taxpayer's residence caused by the acceptance of a business proposition requiring his removal to another part of the country is not a loss incurred in business or

trade which is deductible under the Revenue Act of 1917. (C. B. 2, page 129; Digest A. R. R. 96.)

The subletting of an apartment by a tenant on account of being required to make his residence in another city is held not to be a "transaction entered into for profit." Therefore any loss sustained through such transaction is not deductible from gross income. (C. B. 1, page 124; O. D. 42.)

The last quoted ruling is not sound and should be contrasted with a more recent office decision wherein it was held that a taxpayer who lives in an apartment where it was the custom of the residents to sublease their apartments for the summer months, may deduct the rent paid during the time the apartment was sublet.[51]

Ruling. A taxpayer purchased property in 1917 for use as a personal residence, for which he paid $14x$ dollars. He made additions and betterments costing $4x$ dollars. He used the property as a personal residence until 1919, when he moved elsewhere and rented it. In 1920 he sold the property for $13\frac{1}{2}x$ dollars, and claimed a deduction of $4\frac{1}{2}x$ dollars as a loss arising from the sale.

It is held that if a loss is deductible at all it is deductible under section 214 (a) 5 of the Revenue Act of 1918 as a loss sustained in a transaction entered into for profit. However, the mere renting of property purchased without the intention at the time of purchase of making a pecuniary profit thereon does not constitute a "transaction entered into for profit" within the meaning of the statute, and as the taxpayer in the instant case purchased the property for a home, it was not his intention at the time to subsequently sell it for profit. It is therefore held that any loss sustained is not deductible for the purposes of the Revenue Act of 1918. (C. B. 5, page 141; O. D. 1148.)

The question may well be raised, however, whether, after a taxpayer has discontinued using a dwelling for his residence and rents it to others, he has not at that time entered into a transaction for profit—the ownership of the dwelling no longer representing property held for personal use but an income-producing investment—so that if any loss were sustained upon eventual sale of the property it would be properly deductible.

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[51] C. B. 5, page 122; O. D. 1134.

Individual's share of partnership losses deductible.—

REGULATION. . . . . Where the result of partnership operation is a net loss, the loss will be divisible between the partners in the same proportion as net income would have been divisible, and may be used by the individual partners in their returns of income. (Reg. 33, 1918, Art. 30.)

The loss must be as ascertained at the end of the fiscal year of the partnership even if an individual has not changed his taxable year, as he is permitted to do, from the calendar year to a fiscal year which agrees with that of his firm, nevertheless the item of deduction representing his share of the partnership loss will be the amount shown by the partnership books, and, if a loss has accrued to the partnership between the end of its fiscal year and December 31, the individual must not claim credit therefor until the following year. By that time the apparent loss to December 31 may be absorbed by profits thereafter. The point to observe is that the amount of the deduction should agree exactly with the partnership books (subject to adjustment for tax-exempt interest, etc.) as closed for one full fiscal year.[52]

Individual's share of corporation losses.—When an individual is compelled to pay all or part of a corporation's losses it is important to consider the transaction from the points of view of both sides. It has been decided that a debt forgiven is not income to the debtor.[53] If not income to the debtor, because it was a gift, it would not be deductible by the giver.

In many cases, however, the giver is fully justified in wishing to deduct the payment as a loss and is not concerned with how the debtor treats it.

When payments are made to a corporation to pay its debts or to wipe out a deficit or for any reason other than that of furnishing new capital to continue in business, the giver should specify that the amounts paid to the corporation are loans or advances and not additional payments of capital. If the

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[52] See Chapter XXIX.

[53] *U. S. v. Oregon-Washington R. & Nav. Co.*, 251 Fed. 211, (1918).

loans cannot be repaid the amounts advanced may be charged off as bad debts.

REGULATION. The cancellation and forgiveness of indebtedness is dependent on the circumstances for its effect. It may amount to a payment of income or to a gift or to a capital transaction. . . . . (Art. 50.)

RULING. The surrender of stock for the purpose of wiping out an operating deficit can not be made the basis of a deduction in the returns of the individual stockholders. (C. B. 1, page 126; O. D. 216.)

If the foregoing ruling is sound (which is doubtful, because some elements of a realized loss are present) the stockholders should be able by sale or otherwise to conform to the technical requirements of the Treasury and establish the loss.

Losses in illegal transactions may be deductible.—The Treasury has taken the position that profits arising out of illegal transactions are taxable, but the new regulations are silent as to deductions for losses sustained on illegal transactions.[54] Section 214 (a-5) specifically permits the deduction of all losses incurred in "any transaction entered into for profit."

As stated on page 441, recent federal laws have omitted the word "lawful" and income from gambling transactions is unquestionably taxable. If a taxpayer enters into an illegal transaction he naturally hopes to make a profit out of it. If such profit is realized it is taxable. If it results in a loss, under the law it would seem to be a deduction. The law does not say "any lawful transaction," but only "any transaction."

RULING. . . . . An ultra vires contract is one which is beyond the powers of the corporation which the law does not permit the corporation to enter into. In that sense, it is unlawful, but it is not necessarily for that reason illegal in the sense that it is criminal or violates some positive law. The language from the decisions above quoted brings out this distinction, and in the absence of express language in any of the Revenue Acts refusing deductions to corporations for losses sustained in *ultra vires* transactions, such losses can not be denied as deductions on the theory that they are sustained in illegal transactions.

[54] [Former Procedure] Reg. 45, Art. 141, provided that "losses in illegal transactions are not deductible."

It is accordingly held that the New York corporation mentioned in the statement of facts may claim as a deduction in computing its net income for the year 1917 the losses sustained by it during that year as a result of marginal trading on the stock exchange, even though such corporation had no power under its charter to trade in stocks on a margin. . . . . (C. B. I-1, page 270; L. O. 1092.)

The foregoing opinion overruled Law Opinion 968, C. B. 2, page 212, wherein it was held that losses arising from *ultra vires* acts were not deductible.

WHEN GAMBLING IS LAWFUL, LOSSES ARE DEDUCTIBLE.—

RULING. . . . . It is accordingly held that: (1) The entire amount of winnings from all wagering contracts should be returned in gross income under section 213 (a) of the Revenue Act of 1918, irrespective of the nature of the transaction, whether legal or illegal and notwithstanding the laws of the state in which such contracts are made.

(2) If, under the laws of the state in which the wagering contract is made betting or gambling is prohibited, such transactions are illegal and no deduction may be claimed under section 214 (a-5) of the statute for losses sustained in such illegal transactions, but if the laws of the state in which the wagering contract is made do not prohibit betting or gambling, such transactions are lawful and the entire amount of the losses sustained in the transactions may be deducted from gross income under section 214 (a-5). (Letter to The Corporation Trust Company, signed by Acting Commissioner Paul F. Myers, and dated July 12, 1920.)

It would seem from the foregoing that losses at Monte Carlo are fully deductible.

Losses which are considered capital expenditures.—A corporation faced with a lawsuit, compromised with a third party by paying an amount in settlement of certain claims in order to obtain possession of its properties.

RULING. The Committee finds that an amount paid by the M Corporation to C in 1917 either constituted the purchase price of the interest which he had acquired through the arrangement originally entered into before incorporation between A and B, stockholders, and himself, or that the amount was paid to him by way of compromise to perfect the title of the corporation to certain property. In either event it was not a loss nor was it properly chargeable to the current expenses of the year. It was a capital expense and recoverable

through depletion and depreciation deductions over the life of the property. . . . . (C. B. 5, page 176; Digest A. R. R. 701.)

Losses Arising from Fire, Casualties, Theft, etc.

The law includes among the allowable deductions, in the case of individuals and corporations, all "property" losses "arising from fires, storms, shipwreck or other casualty or from theft, and if not compensated for by insurance or otherwise."[55] Such losses are deductible in full by an individual, irrespective of whether or not the property lost was invested in a business or trade.[56]

RULING. If an automobile is purchased with the intention of using it in a business and it is appropriated to business uses primarily a loss sustained through its sale may be deducted in computing net income notwithstanding its occasional use for pleasure purposes. (C. B. 4, page 163; O. D. 943.)

Since there is provision in the law for business losses, and since Congress provided also for "other" losses, it may be possible to include losses due to destruction of, or damage to, automobiles, yachts and all sorts of personal property. The author is of the opinion that such losses, which are in the nature of personal or family expenses, should not be deductible; but if Congress has deliberately provided otherwise, taxpayers cannot be criticized for claiming the deduction.

RULINGS. A loss sustained by reason of the damage of a pleasure automobile, due to an accident attributable to the icy condition of the streets, is not deductible under the provisions of section 214 (a) 6 of the Revenue Act of 1918, as a loss sustained by "other casualty." (C. B. 3, page 158; O. D. 629.)

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[55] Section 214 (a-6).

[56] [Former Procedure] Under the 1913 law the Treasury took the opposite position. Thus T. D. 2005 (July 8, 1914) definitely asserts that only those losses are deductible which are sustained during the tax year "in trade." Section 5 [a] fifth, of the 1916 law permitted a limited deduction of losses in transactions entered into for profit but not connected with one's business or trade.

The words "other casualty" and "theft" appeared first in the 1916 law [section 5 (a)]. The phrase "and from theft" in the 1916 law is superseded by the phrase "or from theft" in the 1918 law, but the change is purely verbal.

A loss may be claimed by the owner of a business truck demolished in collision with a pleasure car provided that the truck was in use in connection with the business of the taxpayer at the time of the collision. No deduction may be claimed by the owner of the pleasure car wrecked in the collision. (C. B. 4, page 160; O. D. 857.)

The reason for disallowing the losses claimed in the cases covered by the foregoing rulings is not clear. The law states that deductions are to be allowed for "losses sustained . . . . of property not connected with the trade or business . . . . if arising from . . . . casualty . . . ." An automobile is surely "property," whether used for business or pleasure purposes. A "casualty" is defined in the *Standard Dictionary* as "a . . . . serious accident . . . . ; that which occurs by chance; chance." All three cases covered by the foregoing rulings would seem to come within the scope of section 214 (a-6). Furthermore, the principles stated do not agree with the rulings on pages 957-958.

Determination of the loss deductible.—

Regulation. . . . . When loss is claimed through the destruction of property by fire, flood, or other casualty, the amount deductible will be the difference between the cost of the property, less proper adjustment for depreciation, and the salvage value thereof. In the case of property acquired before March 1, 1913, however, the deductible loss is the difference between the fair market value of the property as of that date, less proper adjustment for depreciation, and the salvage value thereof. In any event the loss should be reduced by the amount of any insurance or other compensation received. . . . . (Art. 141.)

In the following cases a part at least of the losses was held to be deductible.

Rulings. A taxpayer's personal residence located on a beach was damaged by a storm, which washed away part of the foundation and so undermined the building as to render its destruction certain if it was not immediately removed. In removing the building to a safer location it was further damaged.

The damage caused by the direct action of the storm and by the removal to avoid further probable damage is held to have arisen from storm and deductible from gross income as a loss within the meaning of section 214(a) 6 of the Revenue Act of 1918. If the

building was moved to prevent further loss from the storm in question, the expense of moving it is also deductible as a loss; but if it was moved to prevent probable losses from future storms, the expense of moving it is regarded as a capital expenditure and should be added to the cost of the building in computing profit in the event of its sale, since the removal to a safer locality presumably increased its value. (C. B. 3, page 159; O. D. 698.)

Damage to the flooring and furniture in the residence of a taxpayer caused by the freezing and bursting of water pipes, and not compensated for by insurance, constitutes a deductible loss. The amount of such loss is the difference between the cost of the flooring and furniture (or the fair market value on March 1, 1913, if acquired prior thereto, and such value was less than the cost), less depreciation sustained thereon, prior to the casualty, and the salvage value of the property. (C. B. 5, page 138; Digest O. D. 1076.)

The Treasury has held that when depreciation has not been an allowable deduction, as in the case of a taxpayer's residence, depreciation need not be considered in determining the gain or loss arising from the sale of the residence.[57] It would appear that the same principle should apply when determining losses in cases such as the one covered by the ruling immediately preceding.

Damages for personal injury.—

RULING. Plaintiff recovered damages on account of injuries sustained in a fall occasioned by reason of tripping over a wire stretched along the curb in front of defendant's residence.

Held, that the amount paid by the defendant does not constitute a loss from "other casualty" within the meaning of section 214 (a) 6 of the Revenue Act of 1918, and that he may not deduct it from his gross income for income tax purposes. (C. B. 4, page 155; O. D. 779.)

Accounting procedure.—Losses by fire, storm, etc., not compensated by insurance should be ascertained without delay and proper entries should be made therefor on the books. The law specifically permits the deduction of such losses "sustained during the year." This means the taxable year, fiscal or calendar, of the individual or corporation. If at the time of

[57] See page 574.

closing the books it is known that a loss has occurred and no adjustment has been made, the closing of the books should be deferred until an adjustment shall have been made, because the loss will not be an allowable deduction in the next period. If the delay is for a considerable time a tentative return can be made and later an amended final return can be substituted therefor.

RULING. When an insured loss occurs in one taxable year and the insurance is not recovered during that year the taxpayer should compute his loss by deducting from the total loss the estimated amount of the recoverable insurance. The loss so determined should be deducted from the taxpayer's gross income of the year in which the loss was sustained. If subsequent events demonstrate that this estimate was substantially incorrect, an amended return should be filed correcting the mistake. (C. B. 1, page 123; Digest T. B. R. 55.)

Losses by theft and embezzlement.—Losses by theft[58] are now specifically mentioned in the law among those which may be deducted.[59]

If newspaper reports are trustworthy, there will be many claims by individuals not in the liquor trade, for losses from theft of liquors. The regulations hold that such losses constitute allowable deductions. The basis of deduction is cost, not market value.

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[58] **[Former Procedure]** The following ruling made in 1919 should be read in conjunction with Art. 146 of Reg. 62.

RULING. A loss incurred by a corporation through embezzlement is an allowable deduction from gross income for the year in which the embezzlement occurred. Where the embezzlement is not discovered in the taxable year but is later discovered and admitted by the embezzler, a part of the money being promptly recovered, the amount so recovered tends to diminish the amount of allowable deduction on account of the embezzlement for the year in which the embezzlement occurred, and is ordinarily not returnable as income in the year when received. . . . . (C. B. 1, page 118; Digest O. 845.)

[59] It is interesting to note that in England losses by embezzlement by an employee have only recently come to be recognized as allowable deductions.

"A loss by reason of embezzlement by an employee used to be looked upon as a loss by stratagem, and not one connected with, or arising out of, trade, and it used to be said that the amount could not be deducted. Such a loss, however, is now for income tax purposes deemed an expense of the year in which it is written off in the books." Murray and Carter, *Income Tax Practice,* page 281.

RULINGS. A loss incurred by a corporation through the embezzlement of securities held in bailment is an allowable deduction from gross income of the year in which the liability accrued, i. e., when demand was made by the bailors for the return of the securities and replacement thereof was made by the corporation. . . . . (C. B. 3, page 158; Digest A. R. R. 269.)

A loss sustained by a corporation through burglary in 1917 is deductible in the taxpayer's return for that year only, although the question as to whether a burglary insurance company should repay all or any part of the loss to the company was not finally determined by the courts until 1919. (C. B. 4, page 143; Digest A. R. R. 542.)

A forwarded to his brother B, $15x$ dollars to be used in the purchase of a bank. During the negotiations for the purchase, C absconded with the money. A expended x dollars as interest upon the sum lost, which was a loan, and x dollars in apprehending the thief. A's brother is unable to make good the loss and no recovery can be had from C.

Held, that A is entitled to deduct the amount of $15x$ dollars as a business loss and in addition the interest payment advanced to secure the loan. The amount expended in apprehending the thief, however, is regarded as a personal expense and may not, therefore, be deducted. (C. B. 3, page 156; O. D. 571.)

During 1916, A was induced by B, who represented himself as an agent of a manufacturing corporation, to invest $10x$ dollars, represented by two notes of $5x$ dollars each, ... B's representations were later found to be false and after discounting one of A's notes he absconded with the proceeds thereof, A having succeeded in recovering the other note. An investigation of the transaction was made in 1916 and it was then found that the parties who had put money into the enterprise would realize nothing from it. During 1917, A paid x dollars on the note discounted at the bank and renewed it for $4x$ dollars, which amount he paid in 1918, and claimed as a loss in computing his net income for that year. The question is raised as to the year in which the loss is properly deductible.

Assuming that A kept his books on a cash receipts and disbursements basis, it is held that he would not be in a position to deduct any loss until he had actually paid the note, thereby evidencing a completed and closed stock transaction. A may deduct the payments on the note in computing net income for the years in which such payments were made. The fact that the loss was discovered in 1916 is immaterial, because the date of discovery does not determine the date on which the loss was sustained. (C. B. I-1, page 149; I. T. 1167.)

A ring was lost by its owner and owing to the circumstances at-

tending the loss he is in doubt as to whether it was stolen or merely misplaced or lost from his finger.

Unless he can establish the fact that the ring was stolen no deduction can be allowed on account of the loss.

Such a loss does not come within the meaning of the term "other casualty" as used in section 214 (a) 6 of the Revenue Act of 1918. This term embraces losses arising through the action of natural physical forces and which occur suddenly, unexpectedly, and without design of the one suffering the loss. (C. B. 2, page 130; O. D. 526.)

The amounts misappropriated by a guardian of a minor in the years 1917, 1918, and 1919 are allowable deductions for those years. . . . . (C. B. 5, page 139; Digest A. R. M. 144.)

But another taxpayer who had a similar loss did not fare so well.

Ruling. A taxpayer employed a contractor to build his house. The contractor absconded, leaving certain bills for material used in the construction of the house unpaid, and the taxpayer was required to pay such bills.

Held, that the additional amount paid represents additional cost of the building and is not deductible as a loss. (C. B. 4, page 213; O. D. 925.)

The Treasury ruled in another case[60] that losses are deductible by amended returns in the years when the funds were converted, and that the recoveries or estimates of probable recoveries "should be allocated to each year in which the funds were embezzled in the proportion that the sum so converted in a particular year bears to the total amount embezzled."

Corporate Losses in Issuance and Redemption of Securities

Discount on bonds sold—a loss which may be prorated.— The regulations provide that bond discount (except for discounts on bonds purchased prior to 1909 and charged off) may be prorated equitably over the life of the bonds.

Regulations. Discount on bonds issued and sold prior to the year 1909, if such discount was then charged against surplus or against the income of the year in which the bonds were sold, is held not to be deductible from the income of subsequent years, for the

[60] I-42-548; I. T. 1470.

reason that the charging off prior to January 1, 1909, of the entire amount of the discount constitutes a closed transaction, and such transaction can not be reopened for the purpose of reducing the taxable income of a corporation for subsequent years by deducting therefrom an aliquot part of the discount. (*C. & A. R. R. v. U. S.*, Court of Claims) (Reg. 33, 1918, Art. 149.)

(1) (*a*) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (*b*) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. . . . .

(2) (*a*) If bonds are issued by a corporation at a premium, ... [and] (*b*) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price minus any amount of premium already returned as income, the excess of the purchase price over the issuing price minus any amount of premium already returned as income (or over the face value plus any amount of premium not yet returned as income) is a deductible expense for the taxable year. . . . .

(3) (*a*) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. (*b*) If thereafter the corporation purchases and retires any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. . . . . (Art. 545.)[61]

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[61] [Former Procedure] Article 545 follows very closely the language of article 544 of Regulations 45. These regulations are those prescribed by the Treasury under its authority to permit and require accounts to be kept on a basis which properly reflects the true net income of taxpayers.

Under the 1909 law the Treasury's hands were more or less tied. The law as written required accounts to be kept strictly on a cash receipt and payment basis. Therefore the decisions of the courts under the 1909 law are of interest only in connection with returns for periods prior to January 1, 1913.

Baldwin Locomotive Works v. McCoach (221 Fed. 59, 136 C. C. A. 660).—

Ruling. The decision of the United States Circuit Court of Appeals for the Third Circuit, in the case of the *Baldwin Locomotive Works v. McCoach, Collector* (221 Fed. 59), holds that if the loss sustained by selling its own bonds at a discount is an expense of the business of a corporation, the expense will not be paid until the maturity of the bonds, and should therefore be prorated over the life of the bonds. (T. D. 2185, April 1, 1915.)

When bond discount has been capitalized at the time of issuance of the bonds (as was frequently done and approved by public service commissions not many years ago), and when such discount has not been otherwise amortized, it appears to be permissible for income tax purposes to write off annually the *pro rata* amount.

When bond discount was charged to profit and loss during the year in which the bonds were issued (if since 1909), or during subsequent years, in amounts greater than the proper proportion, it seems to be permissible to prepare and submit amended returns for such years, or upon any reopening of a corporation's books by the Treasury to make claim for adjustment.

RULING. A corporation which issued its bonds at a discount and improperly charged the discount to profit and loss may correct its books to show the discount treated as interest paid in advance to be amortized over the life of the bonds. Amended returns reflecting correction in the books may be filed. (C. B. 1, page 224; O. D. 111.)

Loss on bonds sold or paid at maturity.—When the amount received from the sale or redemption of bonds purchased prior to March 1, 1913, is less than cost, or fair market value March 1, 1913, (whichever was lower) the difference is an allowable deduction as a loss. If purchased on or after March 1, 1913, the deduction allowed is the difference between cost and the amount realized by sale or redemption.[62]

SOUTHERN PACIFIC R. R. CO. v. MUENTER (260 Fed. 837).—

RULING. Where a corporation sold bonds at a discount during 1906, 1907 and 1908 no deduction from gross income for the years 1909, 1910 and 1911 of sums set aside by the corporation to pay such discount at the maturity of the bonds is permitted under the provisions o fsection 38, Act of August 5, 1909, authorizing corporations to deduct from gross income "(second) all losses actually sustained within the year . . . ." and "(third) interest actually paid within the year on its bonded or other indebtedness. . . . ." (T. D. 2944, November 8, 1919.)

It will be noted that the court strictly construed the terms "losses actually sustained within the year" and "interest actually paid within the year."

[62] Subject to modification by provisions of section 202 (a-2) of 1921 law as to sales of property acquired by gift after December 31, 1920. This modification did not appear in the 1918 law.

If bonds were purchased at a discount or premium and the taxpayer has amortized the difference between par and purchase price, the amount of the loss is based on the book values and not on original cost, except as the value at March 1, 1913, may necessitate further adjustment.

RULING. Amortization of premium or discount on bonds as contemplated in articles 544, 563, and 848, Regulations 45, is not permissible in the case of the purchaser of bonds. The purchase price of the bond, even though different from par represents the investment. When the bonds mature or are sold the basis for determining the gain or loss is their purchase price, or their fair market value as at March 1, 1913, if acquired prior to that date. (C. B. 2, page 211; O. D. 475.)

The foregoing ruling is at variance with good accounting practice. A bank bought 7 per cent bonds at 110 in 1910. In 1920 the bonds were paid off at par. If all the premium had been amortized the books would show no loss in 1920, but under the ruling a loss could be claimed, assuming that the value at market 1913 was not less than par.

RULING. Where bonds mature serially, a proper proportion of the total discount and expenses should be allocated to each series and each series then treated as a separate unit. The deduction applicable to each series should be prorated equally over the life of the bonds constituting the series, provided, however, that if the corporation retired any of the bonds before maturity, the deduction for that year should be increased by an amount equivalent to the amount which would ordinarily be deducted during the succeeding years on account of those particular bonds if they had not been prematurely retired. (C. B. 4, page 276; O. D. 936.)

REGULATION. . . . . If it (a corporation) retires its bonds at a price in excess of the issuing price, such excess may usually be deducted as expense. . . . . (Art. 563.)

Premium on capital stock redeemed not a deductible loss.—

RULING. This office is in receipt of your letter of the 6th instant, in which you ask for information on the following question: "A corporation in 1912 issued preferred stock for par. It was provided on the certificates that said stock was redeemable at 110. The company exercised its option and redeemed the stock at 110 by calling it in. The difference appeared on the books as a reduction of undivided profits. Is this difference a lawful deduction?"

In reply you are informed that this office will hold that the redeeming of the stock at a price in excess of par. represents a capital transaction in which there can be no gain or loss to the corporation, and therefore the difference between the selling price of the stock and the price at which it was redeemed will not be deductible in a return of annual net income. (Letter to a subscriber of The Corporation Trust Co., signed by Deputy Commissioner G. E. Fletcher, and dated April 11, 1917.)

Regulations. The proceeds from the original sale by a corporation of its shares of capital stock, whether such proceeds are in excess of or less than the par value of the stock issued, constitute the capital of the company. If the stock is sold at a premium, the premium is not income. . . . . (Art. 543.)

A corporation sustains no deductible loss from the sale of its capital stock. . . . . (Art. 563.)

The purchase or redemption by a corporation of its own capital stock is an operation of a nature entirely different from that involved in the retirement of bonds. The purchase or retirement of bonds at a premium involves a payment to a creditor. As explained above, the premium is nothing but a net expense spread over the life of the bonds. Payments to stockholders, on the other hand, must be out of profits (unless liquidation is in progress). Such payments are usually in the form of dividends, but in the numerous instances when corporations purchase their own shares at a premium, this premium in effect is a payment to a stockholder. Most states forbid a corporation to buy its own stock except out of surplus. Since the payment of a premium on shares is the equivalent of a dividend, there is no ground whatever for a claim that such premiums should be allowable deductions in an income tax return. In no sense of the word is such a payment capital. Although not an allowable deduction from net income, premiums on stock can be paid only from profits and that is the method always followed.

Consequently the author cannot agree with the Treasury when it says that the payment of the premium in redeeming stock is "a capital transaction in which there can be no gain or loss to the corporation." He does agree, however,

with the conclusion that such payments are not deductible. As such payments are not allowable deductions to the corporation, and must, therefore, be charged direct to surplus, it can be claimed that a distribution of profits, equivalent to a dividend, has been made. The corporation will have paid the normal income tax thereon and should notify its stockholders of that fact so that they may enter the receipt of the premiums as a dividend and thus avoid the normal tax.

Losses of Holding Companies—Accounting Procedure

The interests owned by holding companies in affiliated or subsidiary companies are usually represented by holdings of capital stock, bonds or other forms of indebtedness such as promissory notes, open book accounts, etc. When a holding company desires to reflect on its books the profits or losses of its subsidiaries, it does so by the accrual and reserve method,[63] or by writing up or down the book valuations of the stocks or obligations owned.

Under existing rulings, a mere writing down of valuations is not an allowable deduction. But many transactions ordinarily reflected by a change in valuations are more properly recorded as "losses which are immediately deductible." If a subsidiary loses money and the holding company advances funds, which in effect are used to make good the deficit, and it is not likely that the subsidiary can repay the advance, it becomes a bad debt on the books of the holding company and should be charged off as a loss. The 1921 law specifically authorizes the Commissioner to allow a deduction for a bad debts reserve; when he is satisfied that a debt is recoverable only in part, he may allow it to be charged off in part.

Transactions of this kind are sometimes improperly handled. For example, the advance from the holding company

[63] *Auditing, Theory and Practice,* Vol. I (3rd edition), by R. H. Montgomery, page 347 *et seq.*

to the subsidiary is often treated as a gift from one to the other. If this were really so, the holding company could not claim it as an allowable deduction (because gifts are not deductible); but in fact this is not a gift. It is on the part of the holding company one of the necessary expenses incurred in its business or a loss of similar nature. Holding companies are formed to make money. When they lose in transactions *from which profits were expected to arise,* it is a trade loss—not a gift in the nature of a beneficence or anything of that sort. Therefore at the time when such transactions are entered, the true state of affairs should be disclosed and inadvertent mention of a gift should be avoided.[64]

Decision. (Syl.) Interest accrued, but not actually collected, was not "income," subject to the excise tax imposed by Act Aug. 5, 1909.

Where a railroad company organized a terminal company and was practically the sole stockholder, but the terminal company was a separate legal entity, with separate books and accounts, and managed by a separate set of officers, and its operations were separately conducted, money advanced by the railroad to the terminal company with which to pay operating expenses, which the terminal company's income was insufficient to pay, could not be deducted by the railroad company as a part of the ordinary and necessary expenses of the operation of its business and properties, in computing the excise tax imposed by Act Aug. 5, 1909. (*Walker v. Gulf & Interstate Ry. Co. of Texas,* 269 Fed. 885.)

The law provides that beginning January 1, 1922, consolidated returns or separate returns shall be optional in cases where one corporation controls another or an individual controls two or more corporations.[65] When consolidated returns are made, the loss of one subsidiary operates as a credit against

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[64] **[Former Procedure]** Article 115 of Regulations 33, 1918, required that earnings of subsidiaries taken up on the books of the holding company be returned as income. If the regulations were sound, then the converse must be good practice: that is, where *losses* of subsidiaries are taken up each month on the books of the holding company, they could be claimed as allowable deductions. The author questioned the soundness of the ruling as it affects income, and the same criticism applies where there is a loss.

[65] Section 240 (e), Art. 632.

the profit of another and no adjustments need be made in the books.

It would not be wise, however, to depend on the desired adjustment being made through the medium of consolidated returns. State income tax returns require accurate reports from subsidiaries and in many cases no report at all is required from the parent company or an affiliated company.

Limitation on losses incurred in transactions outside business or trade.—Under the 1918 and 1921 laws all losses incurred in trade, or arising from transactions entered into for profit, are deductible, but under former laws there were limitations on the deductions.

For several years the author has contended that the Treasury did not properly interpret the earlier laws and that many losses which were disallowed were in fact allowable deductions. During 1919 a case was decided in a United States district court wherein the court held that the Treasury was in error in disallowing a loss which the taxpayer claimed as having been incurred in trade. The taxpayer received a large block of stock in an industrial company to whose affairs she evidently devoted some time and attention.

Decision. The transactions . . . . were complicated in character, involved a very large sum of money, and must have required much of her time and attention, and I am of the opinion that they were of the character contemplated by Congress as "incurred in trade." [*Bryce et al. v. Keith*, 257 Fed. 133 (March 26, 1919).]

"Relief" Provisions of the 1921 Law[66]

The radical changes expected in business conditions as a result of the cessation of the war made it seem imperative that losses arising from readjustments of inventories, which might

[66] [Former Procedure] Provision was made in the 1918 law [sections 214 (12-a) and 234 (14-a)] whereby losses resulting from a subsequent decline of a material amount in the value of the 1918 inventory, might be deducted from the net income of that taxable year and the tax be recomputed. An allowance for rebates was also permitted. A full discussion of this subject will be found in *Income Tax Procedure*, 1921, page 787 *et*

occur within a few months thereafter, should be spread over a longer period of time. Similar conditions existed in the case of losses arising from sales or depreciation of plant and equipment acquired for war purposes. To meet these difficulties the 1918 law provided certain so-called relief measures designed to assist in the re-establishment of normal conditions.[67]

The following provision of the 1921 law permits the application of the net loss of one year against the two succeeding years:

Law. Section 204. . . . . (b) If for any taxable year beginning after December 31, 1920, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount thereof shall be deducted from the net income of the taxpayer for the succeeding taxable year; and if such net loss is in excess of the net income for such succeeding taxable year, the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year; the deduction in all cases to be made under regulations prescribed by the Commissioner with the approval of the Secretary. . . . .

There are two principal points of difference between the foregoing provision and the similar provision of the 1918 law:[68]

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seq. As a condition to the allowance of a claim under this provision, the Treasury illegally requires that the disposition of the entire inventory at the close of the 1918 taxable year be shown and that a net loss on the inventory must have been incurred. (C. B. 5, page 169; A. R. R. 554.)

Claims for abatement covering inventory losses under 1918 law carry interest at 1 per cent per month.

For rulings dealing with rebates, see

C. B. 1, page 155; A. R. M. 4.	C. B. 5, page 162; A. R. R. 590.
" 2, " 155; A. R. R. 155.	" 5, " 167; A. R. M. 136.
" 2, " 156; O. D. 382.	" 5, " 130; O. D. 1067.
" 3, " 147; A. R. R. 275.	" I-1, page 126; A. R. R. 921.

As to the deductibility of rebates under 1921 law, see Chapter XXXI.

[67] Referring to these provisions Senator Simmons said:

In addition to the relief amendments placed in the income-tax title, but affecting profits taxes as well as income taxes, amendments relating to amortization and obsolescence, shrinkage in inventories, and so forth, the Senate added a general relief clause investing more or less discretion in the Commissioner of Internal Revenue and the advisory tax board for relief in cases clearly establishing injustice, inequality or discrimination. The House conferees accepted these provisions of the Senate. (*Congressional Record,* Vol. 57, page 3134.)

[68] In ruling C. B. I-1, page 45; I. T. 1179, the Treasury held that "the term 'net loss' as used in section 204 of the Revenue Act of 1918 refers to a net loss attributable to the sale of capital assets as well as to operating losses."

1. The 1918 law permitted the application of the loss first against income of the preceding taxable year (involving a recomputation of the preceding year's tax and a refund of that previously paid) and the application against the following year's income of any excess of loss over income of the preceding year, whereas the 1921 law permits application of loss of one taxable year only against income of one or two succeeding years.

2. The net loss provision of the 1921 law is continuing in its character, whereas that in the 1918 law related only to net losses sustained in the years ended October 31, November 30 or December 31, 1919, respectively.

It will be observed that neither the 1918 nor the 1921 law makes any provision whatever for offsetting losses sustained in 1920 against the income of either preceding or succeeding years.

Definition of "net loss."—

LAW. Section 204. **(a) That as used in this section the term "net loss" means only net losses resulting from the operation of any**

Later, the ruling was reversed in I-31-434; I. T. 1401. The Treasury now holds that that part of a net loss, resulting from the sale of capital assets by a corporation in 1919, cannot be deducted from net income for the taxable year 1918, unless such loss resulted from the sale of assets described in section 204 (a-2), which specifies: "plant, buildings, machinery or other facilities, constructed, installed or acquired . . . . on or after April 6, 1917, for the production of articles contributing to the prosecution of the present war." Notwithstanding the quotations in I. T. 1401 from Senator Penrose and Senator Lenroot, it is believed by some authorities that the phrase, "net losses resulting from . . . . the operation of any business regularly carried on by the taxpayer," includes any loss arising from the sale of capital assets used in connection with the business. The same authorities admit that any losses due to the sale of capital assets which have not been used in the business regularly carried on by the taxpayer are not deductible.

These authorities urge that clause (2) of section 204 was added because many concerns manufactured munitions which were not in their regular line of business and that if clause (2) had not been included, losses arising from the sale of such assets would have been excluded by paragraph 1.

The author believes that the new ruling (I. T. 1401) more nearly accords with the intention of the law than the former ruling. Nevertheless, if it can be shown in any case that a loss arising from the sale of capital assets is a part of the "operation" of a business, the loss should be claimed. The equities are clearly in favor of the taxpayer. The only question at issue is the technical interpretation of the statute.

See also I-45-576; A. R. M. 185.

trade or business regularly carried on by the taxpayer (including losses sustained from the sale or other disposition of real estate, machinery, and other capital assets, used in the conduct of such trade or business); and when so resulting means the excess of the deductions allowed by section 214 or 234,[69] as the case may be, over the sum of the following: (1) the gross income of the taxpayer for the taxable year, (2) the amount by which the interest received free from taxation under this title exceeds so much of the interest paid or accrued within the taxable year on indebtedness as is not permitted to be deducted by paragraph (2) of subdivision (a) of section 214 or by paragraph (2) of subdivision (a) of section 234, (3) the amount by which the deductible losses not sustained in such trade or business exceed the taxable gains or profits not derived from such trade or business, (4) amounts received as dividends and allowed as a deduction under paragraph (6) of subdivision (a) of section 234, and (5) so much of the depletion deduction allowed with respect to any mine, oil or gas well as is based upon discovery value in lieu of cost. . . . .

Section 204 does not apply unless a "net loss" has been sustained. When a taxpayer's profit and loss account shows a loss, as that term is commonly used, further consideration is essential in order to determine "net loss."

Regulation. The term "net loss" as used in the statute means only a net loss resulting from the operation during the taxable year of any trade or business regularly carried on by the taxpayer. Included therein are losses from the sale or other disposition of real estate, machinery, and other capital assets used in the conduct of such trade or business. In order to be entitled to claim an allowance for a "net loss" the taxpayer must have suffered an actual net loss in a trade or business during the taxable year. The amount properly allowable may be neither the loss reflected upon the return filed for the purpose of the income tax nor the net loss shown by the taxpayer's profit and loss account, but is to be computed according to the statute, as follows:

(1) In the case of an individual, it is the amount by which the deductions allowed under section 214, excluding:

(*a*) the amount by which the deductible losses not sustained in such trade or business exceed the taxable gain or profits not derived from such trade or business;

(*b*) so much of the depletion deduction with respect to any mine, oil, or gas well as represents the excess of value based upon discovery subsequent to February 28, 1913, over cost or value as of March 1, 1913; and

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[69] Providing for deductions allowed individuals (section 214) and corporations (section 234).

(*c*) the amount of deductions allowed under section 214 not connected with the trade or business,

exceeds the sum of the following:

(*a*) the gross income of the taxpayer for the taxable year as computed under section 213; and

(*b*) the amount by which the interest received free from taxation under the provisions of the Act exceeds so much of the interest paid or accrued within the taxable year on indebtedness as is not allowed as a deduction under section 214 (a) (2).

(2) In the case of a corporation, it is the amount by which the deductions allowed under section 234, excluding:

(*a*) the amount received as dividends and allowed as a deduction under section 234 (a) (6); and

(*b*) so much of the depletion deduction with respect to any mine, oil or gas well as represents the excess of value based upon discovery subsequent to February 28, 1913, over cost or value as of March 1, 1913,

exceeds the sum of the following:

(*a*) the gross income of the taxpayer for the taxable year as computed under section 233; and

(*b*) the amount by which the interest received free from taxation under the provisions of the Act exceeds so much of the interest paid or accrued within the taxable year on indebtedness as is not allowed as a deduction under section 234 (a) (2).

In computing statutory "net loss" the following restrictions are to be noted:

(1) Interest received by the taxpayer on obligations or securities, the interest from which is exempted from taxation must be included in income, but this amount may first be reduced by the amount of any interest paid by the taxpayer on money used to purchase or carry such obligations or securities.

(2) Where depletion is computed upon the basis of discovery value in lieu of cost or value as of March 1, 1913, in making the computation, the deductions are reduced by that portion of the depletion representing the excess of the discovery value over actual cost or value as of March 1, 1913. . . . . (Art. 1601.)

Computation of "net loss."—

The following official illustration is so clear that it needs no extended comment. The net losses to be carried forward are taxpayer's *business* losses.

Taxpayers may have an apparent loss in 1921 which they hope will serve as an offset against net income in 1922 or 1923.

But careful consideration must be given to what constitutes statutory net loss before they can be certain that the loss or any part thereof is a loss applicable against the income of succeeding years under the provisions of the law.

REGULATION. The method of computation of net losses as outlined in article 1601 may be illustrated as follows: A, an individual conducting a trade or business, finds the following facts relative to a taxable year:

(*a*) His deductions as computed under section 214 amount to $100,000.

(*b*) Included in the deduction is an item of $10,000 for loss by fire of property occupied by him as a residence and not used in connection with his trade or business.

(*c*) Deductible losses on account of transactions entered into for profit outside of the trade or business are $3,000.

(*d*) Taxable gains from transactions entered into for profit and not connected with the trade or business are $5,000.

(*e*) Donations to the Red Cross are included in the deductions in the amount of $1,000.

(*f*) Depletion is claimed in the amount of $2,000, of which $500 is based upon the value of the mineral in the mine as of March 1, 1913, and $1,500 is attributable to increase in valuation on account of discovery subsequent to February 28, 1913.

(*g*) His entire gross income as computed under section 213 is $50,000.

(*h*) Interest received from municipal bonds exempted from taxation by section 213 (b) (4) amounted to $10,000.

(*i*) Interest was paid upon money borrowed to carry municipal bonds in the amount of $8,000, which amount is not deductible in accordance with section 214 (a) (2):

Total deductions (*a*)			$100,000
Deduct:			
Loss by fire (*b*)		$10,000	
Other losses (*c*)		3,000	
Total loss outside business		13,000	
Less: Gain outside business (*d*)		5,000	
Excess of deductible losses not sustained in trade or business over taxable gains or profits not derived from such trade or business		8,000	
Donations (*e*)		1,000	
Depletion on basis of value after discovery (*f*)	$2,000		
Less: Portion based on value as of March 1, 1913	500		

Portion of depletion representing discovery value in excess of cost or value as of March 1, 1913	1,500			
Total exclusion from deductions		10,500		
Total expenses directly attributable to the conduct of the trade or business			$89,500	
Gross income (*g*)		$ 50,000		
Add: Non-taxable interest received (*h*)	$10,000			
Less: Interest paid on money borrowed to carry municipal bonds (*i*)	8,000	2,000	52,000	
Statutory net loss				$37,500

(Art. 1605.)

"Net loss" of taxpayer having fiscal year.—

Law. Section 204. . . . . (d) If it appears, upon the production of evidence satisfactory to the Commissioner, that a taxpayer having a fiscal year beginning in 1920 and ending in 1921 has sustained a net loss during such fiscal year, such taxpayer shall be entitled to the benefits of this section in respect to the same proportion of such net loss which the portion of such fiscal year falling within the calendar year 1921 is of the entire fiscal year.

Regulation. The provisions of section 204 relative to net losses are not retroactive and apply only to taxable years beginning after December 31, 1920, with the following exception: Where a taxpayer has a fiscal year beginning in 1920 and ending in 1921, if the taxpayer produces evidence showing to the satisfaction of the Commissioner that a "net loss" has been sustained during such fiscal year, the benefits of section 204 shall apply to the same proportion of such net loss as the portion of such fiscal year falling within the calendar year 1921 is of the entire fiscal year. The net loss shall be first computed as prescribed in articles 1601 and 1605 for the entire fiscal year ending in 1921 in accordance with this Act as in effect on January 1, 1921. The net loss allowable shall be the same proportion of the net loss for the entire fiscal year as the portion of the fiscal year falling within the calendar year 1921 is of the entire fiscal year. (Art. 1604.)

The foregoing provision merely extends a proportionate deduction to taxpayers whose fiscal years include only part of the year 1921.

Can net loss of period of less than twelve months be carried forward?—Section 204 (a), which provides for the carrying forward of net losses, mentions the period during which

the loss occurs as "any taxable year beginning after December 31, 1920." Section 204 (d) provides that fiscal year concerns may carry forward that part of net losses which accrue after December 31, 1920.

Section 226 provides for returns for periods less than twelve months. Section 226 (a) deals with changes in fiscal periods and permits returns for less than twelve months. Section 226 (b) and (c) deal with the rates of tax and method of computation when returns are made for part of a taxable year. There is no specific provision in the 1921 law[70] which deals with carrying forward net losses when changes in fiscal years occurred during 1921 or which may occur thereafter. It is, however, clear that the intention of Congress is to extend the deduction in every case. There is no inhibition against

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[70] **[Former Procedure]** The 1918 law (section 204) provided that losses in "any taxable year beginning after October 31, 1918, and ending prior to January 1, 1920," might under certain conditions be applied to prior or subsequent periods. As the intention of Congress was clear to limit deductions to the period and dates mentioned, the provision has been strictly construed. The ruling of the Attorney General regarding this matter will be found in C. B. 3, page 83; T. D. 3044; see also C. B. 5, page 169; A. R. R. 554.

The Treasury has held that in order to be entitled to the benefits of section 204 of the 1918 law "The loss must be for a full taxable year (12 months)." (C. B. I-1, page 45; A. R. R. 743.) See also I-40-532; A. R. R. 1128.

The Treasury held in the following ruling that the net loss must be deducted from the "preceding full taxable year."

A corporation filed returns for the fiscal years ended January 31, 1917 and 1918, and then changed from a fiscal year to the calendar year basis, filing a return for the 11-month period from February 1 to December 31, 1918. Returns were filed for the calendar years 1919 and 1920.

There was a net loss in 1919. Held that the "preceding taxable year" was the fiscal year ended January 31, 1918, the 11-month period ended December 31, 1918, not being a "taxable year." The net loss could be deducted in the year ended January 31, 1918, or in the year commencing January 1, 1920, but no part could be deducted in the 11-month period. (I-41-542; I. T. 1465.)

The right to spread net losses which occurred after the Armistice was intended primarily to include the first 10 months of 1918. The foregoing ruling is an extreme example of the unwillingness of the Treasury to carry out the intention of Congress if a technicality can prevent it. It is true that ordinarily 11 months is not a preceding "year," but it is a taxable period and the courts may find that "preceding year" and "preceding taxable period" are synonymous terms.

For other rulings and comment see *Income Tax Procedure,* 1921, pages 784-787.

the deduction when fiscal year changes result in returns for less than twelve months. Section 200 (1) provides that the term " 'taxable year' means the calendar year, or the fiscal year ending during such calendar year." Concerns starting business must select the calendar year or fiscal year basis.

This usually requires a first return covering less than twelve months. It would have been more satisfactory if section 200 (1) had specifically provided that in the case of new concerns and those changing fiscal periods the term "taxable year" should include the first return after starting business or after changing fiscal periods, but in view of the intention of Congress to extend the deduction to all taxpayers, there should be no discrimination against those whose first fiscal periods fortuitously are less than twelve months.

The provisions, or the intent, to tax for part of a fiscal period, even though it is not a taxable year, are broad enough to carry the implication that, if fully taxable for part of a period, taxpayers are fully entitled to the proportionate part of any benefits which apply to a "taxable year."

Section 204 (d) may be deemed to control the action of the Commissioner in extending the right to carry forward net losses even though the net loss period is less than twelve months. The case is not analogous to the procedure under the 1918 law, wherein the precise dates within which the loss was realized were prescribed. The reason for this was that the Armistice was signed on November 11, 1918, and net losses were applied to the period which it was assumed was specifically affected. The provision in the 1921 law is intended to apply to *all* net losses sustained after January 1, 1921.

The Treasury does not agree with the foregoing interpretation.

Ruling. Where a taxpayer is granted permission to change its accounting period and basis for filing its income tax return from the fiscal year ending October 31, 1921, to the calendar year, the fractional period from November 1 to December 31, 1921, is not a taxable year within the meaning of section 204(b) of the Revenue Act of 1921, and is not to be considered a succeeding taxable year against

which the net loss of the taxpayer for the fiscal year ending October 31, 1921, may be applied.

The first succeeding taxable year of such fiscal year would be the calendar year 1922 and the next succeeding taxable year would be the calendar year 1923. (C. B. I-1, page 47; Digest I. T. 1211.)

Partnerships, beneficiaries and insurance companies allowed benefit of net loss provision.—

LAW. Section 204. . . . . (c) The benefit of this section shall be allowed to the members of a partnership and the beneficiaries of an estate or trust, and to insurance companies subject to the tax imposed by section 243 or 246, under regulations prescribed by the Commissioner with the approval of the Secretary. . . . .

In the case of a partnership the deduction would be available to the individual partners in the same proportion as the partnership income is allocated to them.[71] A member, however, cannot segregate the net loss from other income and carry it forward independently. To receive the benefits of the provision a member of a partnership must sustain a loss after including his entire income from all business sources.[72]

RULING. Inquiry has been made whether the word "taxpayer" as used in section 204 (b) of the Revenue Act of 1921 includes individuals, partnerships, and corporations within its scope.

Section 2, subdivision (9), of the Revenue Act of 1921 defines the word "taxpayer," when used in that Act, as including any person, trust or estate subject to a tax imposed by that Act. Subdivision (1), section 2, provides that "the term 'person' includes partnerships and corporations as well as individuals." It will be seen, then, that the word "taxpayer" as used in section 204 (b) of the Revenue Act of 1921 includes corporations within its meaning, but does not include a partnership because a partnership is "not subject to a tax."

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[71] But see page 782.

[72] C. B. 2, page 58; O. D. 430.

[Former Procedure] The discussion of the limitation on losses under former laws is necessarily exhaustive and must be omitted from this volume. See *Income Tax Procedure*, 1920, pages 660-664. Also see previous editions. For Treasury rulings in 1920, 1921 and 1922, see

C. B. 3, page 156; A. R. R. 242.	C. B. 5, page 56; O. D. 1080.
" 3, " 317; A. R. M. 96.	" 5, " 62; O. D. 1071.
" 4, " 46; O. D. 932.	I-1, " 126; A. R. R. 921.
" 4, " 27; A. R. R. 435.	I-31-434; I. T. 1401, which overruled I. T. 1179.

The individual members of a partnership are taxable on their distributive shares of the net income of a partnership, and a net loss as contemplated by section 204 (a) and (b), by a partnership, is deductible by the partners in their individual capacity under the provisions of section 204 (c). (C. B. I-1, page 45; I. T. 1252.)

Net losses of affiliated taxpayers.—

Ruling. If a net loss under section 204 has been sustained by corporations making a consolidated return for 1921, this loss may be claimed as a deduction in the consolidated return for 1922, notwithstanding the fact that the loss was mainly attributable to a subsidiary company and the subsidiary company, though not dissolved, will not be actively engaged in business during the year 1922. (I-28-399; Digest I. T. 1386.)

Claim for net loss to be filed with succeeding year's return.—

Regulation. A taxpayer sustaining a "net loss" such as set forth in section 204, for any taxable year ending after December 31, 1920, may file a claim therefor with his return for the subsequent taxable year. Such claim should contain a concise statement setting forth the amount of the net loss and all pertinent facts relative thereto, including a schedule showing computation of the net loss in accordance with section 204 and articles 1601 and 1605 of these regulations. If the evidence furnished satisfies the Commissioner that the taxpayer has sustained a "net loss" the amount of such net loss may be deducted from the net income of the taxpayer for the succeeding taxable year and if such net loss is in excess of the net income for such succeeding taxable year the amount of such excess shall be carried over and credited against the net income for the succeeding taxable year. (Art. 1602.)

CHAPTER XXXV

DEDUCTIONS FOR BAD DEBTS

The 1921 law specifically provides regarding bad debts that taxpayers may deduct[1]:

1. A reasonable addition to a reserve for bad debts.
2. Part of a debt which is not fully recoverable.

Taxpayers may, if they choose, continue on the old basis, i.e., they may deduct only those bad debts ascertained to be worthless and charged off during the year. This chapter will deal with the procedure to be followed when reserves are maintained, with the types of bad debts which may be fully deducted, and with the determination of their deductibility.

LAW. Section 214. [Individuals] **(a) That in computing net income there shall be allowed as deductions:**

(7) Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part; . . . .

The deduction for corporations [section 234 (a-5)] is exactly the same as that allowed individuals.

REGULATION. Bad debts may be treated in either of two ways—(1) by a deduction from income in respect of debts ascertained to be worthless in whole or in part, or (2) by a deduction from income of an addition to a reserve for bad debts. For the year 1921 taxpayers may, regardless of their previous practice, elect either of these two methods and will be required to continue the use in later years of the method so elected unless permission to change to the other method is granted by the Commissioner. . . . . (Art. 151.)

Bad debt deductions for the year of change in method.—The following regulation aims first to place both classes of

[1] **[Former Procedure]** The 1913, 1916 and 1917 laws read: "debts due to the taxpayer actually ascertained to be worthless and charged off within the year." The change in the 1918 law was merely verbal.

taxpayers, i.e., those who in prior years maintained reserves and those who did not, on the same basis.

While the foregoing regulation, article 151, refers to 1921, it applies equally well to any year in which a change is made to the reserve method.

Regulation. Taxpayers who have, prior to 1921, maintained reserve accounts for bad debts may deduct a reasonable addition to such reserves in lieu of a deduction for specific bad-debt items. Taxpayers who have not heretofore maintained such reserve accounts may now elect to do so, and in such case shall proceed to determine the amount of the reserve that should reasonably have been set up as at December 31, 1920 (which shall not be deducted in computing net income), and in respect of 1921 and subsequent years may add a reasonable addition to such reserve and deduct the amount in computing taxable net income. . . . . (Art. 155.)

Taxpayers who set up reserves in prior years presumably will have at the beginning of the taxable year in which a change is made to the new basis a reserve for bad debts, the credits to which, when made, had not been deducted in prior income tax returns. Therefore, when taxpayers, who have not theretofore maintained reserves, set up the proper reserve for bad debts at the beginning of the year in which the change is made, they are not permitted to deduct the charge therefor from income. The proper charge is to surplus account. The adjustments which affect the income account should be made at the end of the taxable period.

Regulation. . . . . Where a reserve account is maintained, debts ascertained after December 31, 1920, to be worthless in whole or in part, (*a*) if such debts were outstanding at December 31, 1920, should be charged against the reserve and may be deducted from income, in accordance with article 151; (*b*) if such debts arose after December 31, 1920, should be charged against the reserve, and not deducted from income. What constitutes a reasonable addition to a reserve for bad debts must be determined in the light of the facts, and will vary as between classes of business and with conditions of business prosperity. A taxpayer using the reserve method should make a statement in his return showing the volume of his charge sales (or other business transactions) for the year and the percentage of the reserve to such amount, the total amount of notes and accounts receivable at the beginning and close of the taxable year, and the

amount of the debts which have been ascertained to be wholly or partially worthless and charged against the reserve account during the taxable year. (Art. 155.)

The foregoing regulation permits in effect a double deduction for bad debts in the year of change, viz.:

1. Accounts outstanding at the close of the preceding year which proved to be worthless in the taxable year.
2. Accounts arising from business of the taxable year which upon a reasonable estimate may be deemed to be bad.

In the years thereafter, only the addition (for the current year) to the reserve for bad debts is deductible. This might leave in the reserves amounts representing debts arising prior to the beginning of the taxable year, which would never appear as allowable deductions. Taxpayers may reasonably assume, however, that uncollected debts which arose prior to the taxable year, and which could not be collected in the taxable year, are all bad at the end of said year.

Reserves for Bad Debts

It may be assumed that taxpayers in active business carry reserves for bad debts and that those who are not in active business do not.

Those who are not required under good accounting practice to keep books on an accrual basis are not affected by the 1921 law. When a debt is bad, it may be charged off. Taxpayers who do not keep books on an accrual basis should not ordinarily attempt to charge off only part of a debt.

When accounts are kept on an accrual basis, a reserve for bad debts is set up annually or oftener. If a change to the reserve method was made, or permission to change to that method was secured during the taxable year 1922, the addition to the reserve may be claimed as a deduction in the return for that year.

Under the new procedure, in the year of change, we must consider the deductibility of:

1. Debts ascertained to be bad in the taxable year, applying to sales of previous years.
2. Additions to a reserve for bad debts to include transactions of the taxable year.

Under the regulations,[2] taxpayers may deduct for the year of change the items in (1) as well as those in (2). In subsequent years the deduction in the income account for the year as stated in the books of account and in the tax returns will agree for the first time since 1913.

Accounting procedure.—When taxpayers have not maintained reserves for bad debts and desire now to conform to good accounting practice and the regulations, the following procedure is suggested:

1. Set up a reserve for bad debts before closing the books as of the close of the taxable year, which is to be credited with:

   (a) The amount of the reserve which should have been set up at the close of the preceding year.

   (b) An allowance for uncollectible accounts arising from the business of the taxable year, based on the same percentage of the charge sales for that year, which the uncollectible accounts were of the charge sales for the previous three or five years.[3]

2. Charge against the reserve suggested above all the accounts determined to be uncollectible and charged off during the taxable year:

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[2] T. D. 3262 (issued December 21, 1921) did not permit the deduction of both items in (1) and (2). It is assumed that as Art. 155 of Reg. 62 (see page 977) appeared after T. D. 3262 and before any returns for 1921 were made, T. D. 3262 should be wholly ignored.

[3] This allowance must be adequate to provide for (a) the losses which experience indicates will probably be sustained on accounts arising from sales for the taxable year which are uncollected at the end of that year, and (b) any accounts for sales of the same year which were determined to be uncollectible and written off within the year.

(a) The aggregate of accounts accrued prior to the beginning of the taxable year.

(b) The aggregate of accounts accrued during that year.

3. The allowable deduction for bad debts in the return for the taxable year is 2 (a) plus 1 (b). For subsequent years the deduction is 1 (b) for the current year. When taxpayers have maintained reserves in prior years, the deduction for income tax purposes is exactly the same as outlined above.

At the end of each year thereafter, there would be credited to the reserve simply a percentage on the charge sales of the year; all accounts finally decided within the year to be uncollectible would be written off against the reserve plus specific extraordinary items, in whole or in part, which are not included in the normal percentage. After the year of change of method, it would not be necessary to distinguish as to the year's sales from which the written-off accounts arose.

The 1921 law provides that debts that are bad "in part" may be deducted, and the regulations state that: "Partial deductions will be allowed with respect to specific debts only."

At the end of each year the balance in the reserve account naturally will have to be reviewed for the purpose of determining whether the percentage used in computing the credit to the reserve for the year is adequate or whether it may be either too high or too low, in view of more recent experience. The percentage will, of course, need to be modified to whatever extent additional experience indicates to be necessary.

A reserve is excessive or insufficient in 99 out of 100 cases. If grossly excessive, it would be proper to file amended tax returns; but, if at the time the reserve was set up the reserve was a proper one, any subsequent favorable change would be reported as income for the subsequent year. If the reserve was insufficient, the Treasury holds that amended returns must be made.[4] This would not apply unless the insufficiency was substantial.

[4] C. B. I-1, page 160; I. T. 1341, I-37-479; I. T. 1442.

From the foregoing it is apparent that taxpayers who have not heretofore maintained reserves for bad debts should immediately apply for permission to adopt the reserve basis. In effect, they will secure a double deduction for the year of change. Taxpayers already maintaining reserves but who have not changed to the new basis for their tax returns, will secure a like benefit[5]

Only Bona Fide Debts Deductible

If an item claimed as a bad debt partakes of the nature of a gift more than of that of a loan, or if, arising during a period when it could or should have been reported, it has not been included in the federal tax reports as gross income, it is not deductible as a bad debt.

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[5] [Former Procedure]

Effect on invested capital of establishing reserve for bad debts at beginning of 1921.—Taxpayers who previously had not maintained reserves, if they elected the reserve method, were required to set up "the reserve that should reasonably have been set up as at December 31, 1920 (which shall not be deducted in computing net income)." The charge was to surplus. The reserve might be included as invested capital from the beginning of the year, even though the amount of such reserve was deducted in effect from 1921 income through charging to such reserve during 1921 those accounts outstanding at the beginning of the year which proved in 1921 to be bad. Such bad debts, under article 155, were deductible from 1921 income. The reserve at the beginning of the year should be regarded as segregated surplus. The charges against such reserve affected the 1921 income and therefore should not reduce invested capital for 1921.

The Treasury, however, does not agree fully with this position.

Ruling. Under the provisions of Treasury Decision 3262 the reserve set up as at December 31, 1920, is not deductible in computing net income and consequently may be included in invested capital to the extent not utilized to liquidate debts outstanding at December 31, 1920, subsequently determined to be worthless. (Extract from letter of Commissioner Blair, dated March 7, 1922.)

Again, the reserve set up at the beginning of 1921 would not be deducted from accounts receivable in computing admissible assets, which meant that the percentage of inadmissibles would be smaller.

Loans to friends or relatives.—A question in the *Income Tax Primer* reads as follows:

RULING. If, on account of friendship or relationship I advanced a certain sum to assist a needy friend or relative, and at the time such advance was made I had little or no reason to expect that the amount so advanced would ever be returned, may I now claim a deduction to cover such advance?

No. Such an advance, partaking, as it does, somewhat of the nature of a philanthropic donation or a goodwill offering, is not held to constitute a bona fide debt. (*Income Tax Primer,* 1918, question 94.)

Where the element of gift is absent, the Treasury permits the deduction.[6]

Income corresponding to bad debt must have been reported in tax returns.—

REGULATION. Worthless debts arising from unpaid wages, salaries, rents, and similar items of taxable income will not be allowed as a deduction unless the income such items represent has been included in the return of income for the year in which the deduction as a bad debt is sought to be made or in a previous year. . . . (Art. 152.)

This regulation applies particularly to taxpayers who have rendered returns based on cash receipts and payments. It is well illustrated by the following quotation from the *Income Tax Primer:*

RULING. A professional man earned a fee in 1916. As he keeps no books, he reports his income for tax purposes on an actual receipt basis. As this fee has never been reported as income, can it be claimed as a deduction if collection can not be made?

No; never having been returned as income it can not be claimed as a deduction. (*Income Tax Primer,* 1918, question 96.)

It must be understood, however, that the rulings quoted do not debar one from claiming the deduction of an item as a bad debt, even though the corresponding income has not been reported, in case the account arose before the federal income tax laws were in force. The effective date for corpora-

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[6] C. B. 4, page 173; O. D. 934.

tions, under the excise tax law, is January 1, 1909, and for individuals, under the general income tax law, it is March 1, 1913. Debts existing and carried as good on these dates may be treated as allowable deductions if subsequently found to be uncollectible. The entire amount may be deducted in the return of the year during which the debt was found to be bad.

Special Types of Bad Debts—How Valued

Bankruptcy claim—extent to which deductible.—

REGULATION. . . . . Only the difference between the amount received in distribution of the assets of a bankrupt and the amount of the claim may be deducted as a bad debt.

Claims against decedent's estate—extent to which deductible.—

The difference between the amount received by a creditor of a decedent in distribution of the assets of the decedent's estate and the amount of his claim may be considered a worthless debt. . . . (Art. 152.)

Debt ascertained to be bad after decedent's death.—

RULING. The amount paid by the administrator as the decedent's share of a note upon which he was a coindorser, which amount was not determined at the time of the decedent's death, is not deductible in the return for the decedent, but is deductible by the administrator, if the debt is uncollectible, in his return for the estate for the taxable year in which it was paid and charged off on his books.

The difference between the amount paid by the administrator in taking up paper indorsed by the decedent and the appraised value of the claim subrogated to the administrator is not deductible by the administrator until the claim has been disposed of and the transaction is closed and completed. (C. B. 2, page 137; Digest O. D. 556.)

This ruling must be qualified by the provision of section 214 (a-7) relating to debts recoverable only in part.

Accounts receivable purchased—basis for deduction.—

REGULATION. . . . . A purchaser of accounts receivable which can not be collected and are consequently charged off the books as bad debts is entitled to deduct them, the amount of deduction to be

based upon the price he paid for them and not upon their face value. (Art. 152.)

Notes receivable—basis for deduction.—

Regulation. . . . . If a taxpayer computes his income upon the basis of valuing his notes or accounts receivable at their fair market value when received, which may be less than their face value, the amount deductible for bad debts in any case is limited to such original valuation. . . . . (Art. 151.)

The entry of notes at less than their face value is equivalent to the creation of a reserve for bad debts. The Treasury denied the privilege to taxpayers evidently when it was not their "practice" to take up the notes at market value.

Worthless bonds.—

Regulation. Where bonds purchased before March 1, 1913, depreciated in value between the date of purchase and that date, and were in a later year ascertained to be worthless and charged off, the owner is entitled to a deduction in that year equal to the value of the bonds on March 1, 1913. Bonds purchased since February 28, 1913, when ascertained to be worthless, may be treated as bad debts to the amount actually paid for them.[7] Bonds of an insolvent corporation secured only by a mortgage from which on foreclosure nothing is realized for the bondholders are regarded as ascertained to be worthless not later than the year of the foreclosure sale, and no deduction for a bad debt is allowable in computing a bondholder's income for a subsequent year. . . . . (Art. 154.)

A new provision is found in article 154 of Regulations 62, permitting taxpayers to deduct part of the cost of bonds when it can be shown that the holder will recover a smaller amount. This is in accordance with the statute, which permits "part" of a debt to be deducted. Bonds of traction companies whose hope of revival is small are examples.

Regulation. . . . . A taxpayer (other than a dealer in securities) possessing debts evidenced by bonds or other similar obligations can not deduct from gross income any amount merely on account of market fluctuation. Where a taxpayer ascertains, however, that

[7] Reg. 45, Art. 154 (1919 edition), read: "but not exceeding their amortized value if purchased at a premium." Since the Treasury did not permit the premium on bonds purchased to be amortized, the limitation was unnecessary. (C. B. 2, page 211; O. D. 475.)

due, for instance, to the financial condition of the debtor, or conditions other than market fluctuation, he will recover upon maturity none or only a part of the debt evidenced by the bonds or other similar obligations and is able to so demonstrate to the satisfaction of the commissioner, he may deduct in computing net income the uncollectible part of the debt evidenced by the bonds or other similar obligations. (Art. 154.)

Interest accrued, not collectible.—A firm of cotton factors advanced money to shippers of cotton against which advances the factors held the cotton shipped, the proceeds of the sale of said cotton when sold being credited to the account. Interest on these accounts was charged and credited to income. As a result of the drop in the price of cotton in 1920, the cotton factors estimated that in a large number of cases they would not be able to collect part of the principal, to say nothing of the interest, and asked permission to be allowed to omit the interest from income account. The Treasury held that the interest must be taken up as income, but that the interest which was uncollectible at the end of 1920 should be charged off to bad debts.[8] Under article 151, the uncollectible part of the principal could also be charged off as a bad debt.

Debts held prior to March 1, 1913—basis for deduction.—

REGULATION. . . . . To authorize a deduction for a bad debt on account of notes held prior to March 1, 1913, their value on that date must be established.[9] (Art. 154.)

Obviously if a taxpayer in 1922 charged off a debt which had been carried as good since March 1, 1913, it would be reasonable to inquire whether or not on that date the debt was deemed to be good. But the mere fact that on that date there was some doubt as to its value would not mean that

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[8] C. B. I-1, page 52; A. R. R. 737.

[9] [Former Procedure]

REGULATION. "All debts representing amounts that became due and payable prior to March 1, 1913, and not ascertained to be worthless prior to that date, whether representing income or a return of capital, are held to be allowable deductions, under paragraph B of the law, in a return of income for the year in which they are actually ascertained to be worthless and are charged off." (T. D. 2224, July 13, 1915.)

the deduction was an improper one in 1922. Until the passage of the 1921 law, the Treasury always held that no debt could be charged off until it was 100 per cent bad. Subsequent transactions with a debtor would indicate *prima facie* that the debt was collectible at March 1, 1913.

Decision. . . . . The defendant contends that the taxpayer is entitled to charge off only the amount of the actual value of the bonds on March 1, 1913; that the burden is on the taxpayer to establish this amount, and since there is no evidence to show what the bonds were actually worth on that date the entire deduction should be disallowed.

The plaintiff contends that all the statute requires him to prove is that the debt was ascertained to be worthless and charged off within the year 1913. This he has done by the undisputed evidence. The effect of so construing the statute may be to permit the taxpayer to deduct five-sixths[10] of a loss accruing prior to the commencement of the taxable period, so that the return will not reflect his entire income for that period. But Congress has the right to do this, and has done it if the statute is to be literally construed. In case of doubt a tax law should be construed in favor of the taxpayer. *Gould v. Gould,* 245 U. S. 151. Therefore, I conclude that the taxpayer's contention should be sustained. But, even if the burden is on him to prove the value of the bonds on March 1, 1913, I think he has met the burden because the amount at which the bonds stood on his books on March 1, 1913, is at least prima facie evidence of their actual value at that time. *Morton F. Plant. v. Walsh, Collector,* U. S. Dist. Ct., Conn., 280 Fed. 722, April 12, 1922.

Debts Must Be Actually Ascertained to be Worthless in Whole or in Part

The law specifies that a debt to be deductible as bad must be "ascertained to be worthless" [section 214 (a-7)], and it also specifies that "the Commissioner may allow such debt to be charged off in part."

When is a debt worthless?—In describing the deductions permitted to individuals the regulations set up the following general standards.

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[10] Five-sixths only was allowed because the income tax law was not in effect the first two months of 1913.

Debts entirely worthless.—

Regulation.[11] . . . . Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for the purpose of deduction. . . . . (Art. 151.)

Debts partly worthless.[12]—

Regulation. . . . . Where all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. No deduction shall be allowed for the part of a debt ascertained to be worthless and charged off prior to January 1, 1921, unless and until the debt is ascertained to be totally worthless and is finally charged off or is charged down to a nominal amount, or the loss is determined in some other manner by a closed and completed transaction. Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible. . . . . In determining whether a debt is worthless in whole or in part the Commissioner will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. Partial deductions will be allowed with respect to specific debts only. . . . . (Art. 151.)

If part of a debt was ascertained to be worthless and was charged off prior to 1921, the Treasury under previous practice would not allow the deduction. The entire amount had to be worthless and be charged off. It appears that the Treasury will not now allow the partial write-off, previously denied, to be deducted in the return until the entire amount of such debt is ascertained to be totally worthless.

For example, if an account for $1,000 was written down to $600 in 1920, the $400 deduction was disallowed if claimed

[11] [Former Procedure] The following sentence in Reg. 45, Art. 151, which does not appear in Reg. 62, indicates former procedure: "An account merely written down . . . . is not deductible."

[12] [Former Procedure] For rulings when compositions and other settlements were made, see *Income Tax Procedure,* 1921, pages 829-831.

in the 1920 return. It would, however, have formed part of the reserve set up as of January 1, 1921, and if not collected by December 31, 1921, the entire $1,000 would no doubt have been deductible in 1921.

Test is exhaustion of ordinary means to collect.—

Ruling. A creditor, unaware of the financial status of his debtor, who has exhausted all ordinary means for the recovery of an account receivable so that any further attempt to collect a balance due would entail an expense in excess of the amount involved, may deduct the uncollectible balance as a bad debt in his return for the year in which found to be uncollectible and charged off. (C. B. I-1, page 154; I. T. 1172.)

In a more recent case, involving in effect a determination of whether "the surrounding and attendant circumstances" warranted charging off a bad debt in 1916 rather than in 1917, the Treasury held:

Ruling. . . . . It would appear from such evidence as has been submitted that the A estate, including the O Company and the P Company, was hopelessly involved as early as October, 1916, and that the only feature which held out a hope for any substantial recovery on the accounts due the M Company was the indorsement of B on such notes as the appellant company held and the understanding that he was the guarantor of the open accounts. The accountant who audited the books of the appellant company and also the books of Q partnership evidently considered all the accounts he charged off as worthless. B and C, the appellant company's president and treasurer, respectively, apparently took no exception to this view of the accountant until more than three years later, as both signed the 1916 tax return in which the accounts charged off were claimed as a deduction. B was undoubtedly thoroughly familiar with his own financial condition and the financial condition of the Q partnership, the A estate, the O Company, and the P Company at the close of 1916, and knew the value of his indorsement on the notes of the A estate held by the appellant company, and it appears that C also had a very thorough knowledge of such conditions. These two men, therefore, were probably in a better position than anyone else to judge what the probabilities were for any recovery on the accounts due the appellant company, and, as officers of the appellant company, they certified as to the correctness of a tax return in which the said accounts were reported as worthless. The commercial agency undoubtedly held the belief that as late as 1917 the Q partnership was solvent, but the fact remains that in the following month a creditors'

petition was filed to have that firm, of which B was the principal member, declared bankrupt, and such declaration was duly made in——, 1917.

. . . .

The accountant who audited the appellant company's books evidently had knowledge of the financial condition of the A estate, the O Company and the P Company, regarded their accounts as worthless, and charged same off to profit and loss. The president and treasurer of the appellant company apparently took no exception to this action, and in effect affirmed same when they executed the 1916 tax return in which the amounts so charged off were claimed as a deduction.

In the opinion of the Committee the surrounding and attendant circumstances were such at the close of 1916 as to justify the belief that but little, if anything, would ever be collected in discharge of the said accounts, and that no action which could be brought against the debtors themselves or against B as the indorser of the A estate notes to enforce collection would be productive of satisfactory results. Such being the case, the appellant company possessed the right to claim a deduction of $22x$ dollars for the year 1916 and having charged the said accounts off its books and claimed their amount as a deduction it can not now be permitted to cancel such "charge off" and claim that amount as a deduction for a later year. . . . . (C. B. I-1, page 156; A. R. R. 806.)

Again, by denominating a "loss" as a "bad debt," the Treasury has attempted to deny a deduction in 1919 for notes that were forgeries, even though apparently the taxpayer had such knowledge before filing its 1919 return, as appears from the following:

Ruling. . . . . During the year 1919, the M Company discounted certain promissory notes presented by A, which notes were secured by mortgages on personal property and totaled in amount $22x$ dollars. A claimed that he had received these notes in payment of property sold by him. The records also show that the appellant company advanced to A $3.6x$ dollars, which advances were secured by bills of sale for property A claimed to own. In 1920, A committed suicide, and it was then discovered that the notes and mortgages were all forgeries; that he owned no property and was hopelessly insolvent at the time he secured the advances.

In preparing its income and profits tax return for the year 1919 the appellant company claimed the deduction of $25.6x$ dollars under the head of "Losses" to cover the total amount disbursed in discounting the said notes and making the said advances on the theory that such amount became a loss as soon as it was paid to A. . . . .

The records in the case show that in April, 1920, the revenue agent in charge submitted this same question to the Commissioner for a ruling. It came before the Solicitor, and in June, 1920, he ruled with respect to the said notes, mortgages, and bills of sale that—

While the elements of fraud and crime are involved in the transactions in question, yet the losses, if any, incurred by the taxpayer appear to be essentially bad debts rather than other losses. Therefore, they are deductible in accordance with 214 (a) 7 of the Act in the taxable year when they are ascertained to be worthless and charged off irrespective of when they actually became worthless.

In view of the above stated opinion of the Solicitor, in which the Committee concurs, it is recommended that the action of the Income Tax Unit in holding that the said amount of 25.6*x* dollars represented a debt due from A to the M Company which was not deductible in the computation of income tax liability prior to 1920, the year in which it was first ascertained that the said debt was worthless and uncollectible, be sustained. (I-29-412; A. R. R. 965.)

The foregoing rulings are quoted in full to show how difficult it is to apply general principles to tax cases. In A. R. R. 806 the taxpayer was held to the deduction in 1916 (a low tax year) because the debts were charged off in the 1916 tax returns. No mention is made of the fact that tax returns are not made out until several months after the end of a taxable year.

In A. R. R. 965, the taxpayer actually charged off the bad debts in 1919 and included them in the 1919 tax return, but the Solicitor found that the deduction should be made in 1920.

Loss due to seizure of property by Russian Soviet government.—Credits in Russian banks,[13] purchased through New York, and deposits[14] in Russian banks, taken over by the Soviet government, were held, in effect, to be bad debts.

Accounts uncollectible because of moratorium in Cuba.—

Ruling. As a result of the moratorium in Cuba certain accounts due from customers there were uncollectible at the close of the taxable year 1920. Held, that these accounts can not be deducted as bad debts until it has been definitely ascertained that they are

[13] C. B. 3, page 165; A. R. M. 64.
[14] C. B. 2, page 137; O. D. 535; also C. B. 4, page 173; O. D. 923.

worthless and are charged off the books. (C. B. 4, page 173; O. D. 891.)

Under the 1921 law taxpayers may make a reasonable estimate of the amount uncollectible in such a case and deduct such amount from income. The loss claimed must be determined with respect to each account separately.

Depreciation of collateral security.—When a debtor who has put up collateral is known to be unable to pay and the collateral security is worth substantially less than the amount of the debt, there is no good reason why the taxpayer should be compelled to sell the collateral, or make a "wash" sale of it, in order to charge off the loss which has been sustained.

It is clear, under the 1921 law, that an accrued loss of 50 per cent of a debt, when determined by recognized methods of accounting, is as deductible as a loss of 100 per cent.[15]

RULING. The difference between the amount loaned on and secured by cotton in a warehouse and the market value of the same cotton on December 31 of the taxable year is not considered a bad debt within the meaning of section 234 (a) 5 of the Revenue Act of 1921 and Treasury Decision 3262. (C. B. I-1, page 155; I. T. 1183.)

But if the loan is believed to be worth no more than the collateral, the difference is a debt or a loss and is deductible.

WHEN DEBTOR CORPORATION BECOMES INSOLVENT.—The statements in article 151 are couched in terms broad enough to include all debts due the individual whether from corporations or from other individuals.

In cases of insolvencies the test is: What, if anything, can be obtained in liquidation.[16] Even though the corporation is still a going concern, if full recovery could not be had on foreclosure, the 1921 law would warrant charging off the debt in part.[17]

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[15] See also C. B. 3, page 167; A. R. R. 352.
[16] C. B. 2, page 138; A. R. R. 30.
[17] See C. B. 4, page 172; A. R. R. 365, holding that loss under impending foreclosure was not sufficient.

Bankruptcy as a test.—

Regulation. . . . . Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt. Actual determination of worthlessness in bankruptcy cases is sometimes possible before and at other times only when a settlement in bankruptcy shall have been had.[18] Where a taxpayer ascertained a debt to be worthless and charged it off in one year, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, confirming the conclusion that the debt is worthless, will not authorize shifting the deduction to such later year. In the case of debts existing prior to March 1, 1913, only their value on that date may be deducted upon subsequently ascertaining them to be worthless. . . . . (Art. 151.)

The present regulation distinguishes "unsecured and unpreferred debts" from others, indicating that in practically all cases of bankruptcy there may immediately be charged off at least a part of "unsecured or unpreferred debts."

Foreclosure sale on a mortgage.[19]—

Regulation. Where mortgaged or pledged property is lawfully sold (whether to the creditor or other purchaser) for less than the amount of the debt, and the mortgagee or pledgee ascertains that the portion of the indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, and charges it off, he may deduct such amount as a bad debt for the taxable year in which it is ascer-

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[18] [Former Procedure] Article 8 of Regulations 33, 1918, stated that the "determination of worthlessness in such cases is possible only when settlement in bankruptcy shall have been had."

Article 151, Reg. 45, read: "Bankruptcy may or may not be an indication of the worthlessness of a debt." But see C. B. 3, page 167; A. R. R. 352.

[19] [Former Procedure]

Regulation. Where under foreclosure a mortgagee buys in the mortgaged property and credits the indebtedness with the purchase price, the difference between the purchase price and the indebtedness will not be allowable as a deduction for a bad debt, for the property which was security for the debt stands in the place of the debt. The determination of loss in such a situation is deferred until the property is disposed of, except where a purchase money mortgage is foreclosed by the vendor of the property. . . . . Only where a purchaser for less than the debt is another than the mortgagee may the difference between the debt and the net proceeds from the sale be deducted as a bad debt. (Reg. 45, Art. 153.)

T. D. 3264 and 3265 (both dated December 21, 1921) amended the regulations under the 1918 and 1917 laws, respectively, to read in accordance with Reg. 62, Art. 153, quoted above.

tained to be wholly or partially worthless and charged off. Where a taxpayer buys in mortgaged or pledged property for the amount of the debt, no deduction shall be allowed for any part of the debt. Gain or loss is realized when the property bought in is sold or disposed of.

Accrued interest may be included as part of the deduction only when it has previously been returned as income. (Art. 153.)

The foregoing regulation recognizes that the purchase of mortgaged property by the mortgagee for less than principal and accrued interest, demonstrates that the debt is bad "in part" and such "part" may be deducted.

The Treasury has held that upon foreclosure, when the proceeds were sufficient to satisfy only the first mortgage, the amount of the second mortgage may be charged off if action against the mortgagor would be useless.[20]

When a creditor bids up to the amount of his claim when property is offered for sale, it is *prima facie* evidence of its value, and the regulation is in order. But if it can be shown that the property acquired is not worth the amount of the claim, and that the bid was merely formal, the law permits the deduction of any part of the debt which is bad.

Recoveries.—In some cases debts presumably "definitely ascertained to be worthless" have unexpectedly proved to be collectible in whole or in part. The following regulations provide for the taxation of such collections.

Regulations. . . . . Bad debts or accounts charged off subsequent to March 1, 1913, because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off. . . . . (Art. 51.)

. . . . Any amount subsequently received on account of a bad debt or on account of a part of such debt previously charged off, and allowed as a deduction for income tax purposes, must be included in gross income for the taxable year in which received. . . . . (Art. 151.)

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[20] C. B. 3, page 166; O. D. 687.

If collections are made from accounts charged off prior to March 1, 1913, it may be assumed that on that date *at least* as much as the amount collected, exclusive of interest was good. Therefore there can be no element of taxable income in such recoveries except as to interest accrued after March 1, 1913. The requirement that recoveries from accounts arising out of transactions since March 1, 1913, be included in current income instead of reopening the accounts and returns of prior years, is reasonable.

Loss of endorser or guarantor—when determined.—Upon the failure of the maker of a note to take it up at maturity, the endorser may have to pay and thereupon a debt due to the endorser arises. Strictly speaking, it may not be "ascertained to be worthless" immediately, but everyone knows that ordinarily the chances are at least 99 to 1 that it will be a bad debt and usually it takes very little time to reach this conclusion. After allowing a reasonable time in which to ascertain why the maker does not make good, the endorser should charge it off as a bad debt, taking credit for it in his return.

The right to deduct the bad debt is governed by the regulations cited. There is no requirement that the obligation to pay a note as endorser or guarantor shall have arisen from business or trade, so that the restrictions of earlier years as to losses would not apply in any case.

RULING. Where a person purchases bonds for another, guaranteeing said bonds against any loss, and a loss occurs due to subsequent insolvency of the corporation issuing same, and the guarantor makes good the loss, the same is not deductible within the meaning of section 214, article 141, of the Revenue Act of 1918, unless such loss occurs in trade or business or in a transaction entered into for profit. (C. B. 1, page 125; O. D. 241.)

The author does not agree with the foregoing ruling. It is unreasonable to presume that the guarantor cited in the above ruling was willing to guarantee the bonds without an expectation that some element of profit would accrue to him. It is difficult at times to distinguish between a bad debt and

a loss, but when a debt to the taxpayer is created and the debt becomes bad, the law permits a deduction therefor in all cases.

Liability as endorser at March 1, 1913.—

Ruling. . . . . The records in the case show that in the year 190– and subsequent thereto, A indorsed certain notes issued by the M Company and also certain notes issued by the N Company, which companies became insolvent prior to March 1, 1913, and A thereupon became liable as indorser for payment of said notes, since which time he has made certain payments of principal and interest.

. . . . it appears clear that A has never become primarily liable for payment of the principal of the said notes or the interest thereon, nor has he ever given any written agreement to make such payment. As the original notes became due they were renewed, in the names of the original makers and were indorsed by A. Had the latter, upon default in payment of the notes prior to March 1, 1913, then given his own note or notes in payment, a debt would have been created upon his part which would have precluded the allowance of deductions claimed to cover payments made in liquidation of his own notes, inasmuch as payments made in liquidation of an indebtedness created prior to March 1, 1913, can not, under the provisions of any income tax law enacted since that date, be allowed as deductions.

In the opinion of the Committee, A suffered no actual loss through his indorsement of the said notes until he made his first payment in liquidation of their principal and interest thereon. When a payment was made it created a debt in his favor due from the makers of the notes, which debt was at the time it was so created definitely known to be worthless and uncollectible. Each additional payment created an additional bad debt.

In view of the foregoing the Committee recommends that the action of the Income Tax Unit in disallowing the deductions claimed by A for the years 1917, 1918, and 1919 to cover amounts paid in liquidation of the said notes and interest thereon be reversed, and that the said deductions be allowed in the amounts as claimed. (C. B. 5, page 146; A. R. R. 479.)

The reasoning in the foregoing ruling would apply to transactions after March 1, 1913, as well, and enable taxpayers to take a deduction as payments are made on the theory that each payment "creates" a debt from the maker, which is known to be worthless.

Bad debts of banks and other corporations, under government supervision.—A new provision is found in the regulations under the 1921 law, as follows:

REGULATION. . . . . Where banks or other corporations which are subject to supervision by Federal authorities (or by State authorities maintaining substantially equivalent standards) in obedience to the specific orders, or in accordance with the general policy of such supervisory officers, charge off debts in whole or in part such debts shall, in the absence of affirmative evidence clearly establishing the contrary, be presumed, for income tax purposes, to be worthless or recoverable only in part, as the case may be.[21] (Art. 151.)

Debts Must Be Charged Off Within the Year

Charging off bad debts.—The 1921 law requires in the case of individuals and corporations that bad debts must be charged off within the taxable year.[22] These words would seem to require that actual book entries be made by both corporations and individuals in case they desire to claim deductions for bad debts. However, the answer to question 90 of the *Income Tax Primer* interpreting the 1917 law which used the same phrase in describing the conditions which are necessary to claim a debt as a deduction reads: *"If books are kept* it must be charged off within the year," plainly implying that it is still deductible when no books at all are kept.

"Within the year."—The phrase "within the year" refers to "the year for which the return is made."[23] To be deductible the debts must be charged off or included in a reserve which is charged off.

In the case of corporations, deductions for bad debts prior to the 1918 law were classified as business losses and these, it will be recalled, had to be "actually sustained and charged off within the year." [1917 law, section 12 (a) second.]

[21] [Former Procedure] Under Reg. 45, Art. 144, losses of this type were not deductible.

[22] [Former Procedure] The 1913, 1916, 1917 and 1918 laws all contained a similar requirement.

[23] Sec. 214 (a-7).

The term "within the taxable year" should be construed in an accounting sense, that is, if books of account are closed as of December 31 and an entry written in the books during January is dated December 31, the entry is deemed to have been made within the year ended December 31.

CHAPTER XXXVI

DEDUCTIONS FOR DEPRECIATION

Depreciation is a decline in the value of property such as may reasonably be expected to occur as a result of wear and tear and gradual obsolescence. It is due to the possession and use of assets, and therefore is a part of the cost of operation. P. D. Leake defines it as "expired outlay upon productive plant." The phrase "accrued renewals" sometimes used to describe depreciation is illuminating. It is to be noted that depreciation is usually treated as a comprehensive term which includes all declines of the nature described above.[1]

Ruling. Depreciation of fixed assets continues whether a taxpayer earns an income or suffers a loss, and its earned surplus should be reduced on account of depreciation, although it sustained a loss for the taxable year. . . . . (I-36-494; I. T. 1440.)

The Treasury's definition is:

Ruling. Depreciation means the gradual reduction in the value of property due to physical deterioration, exhaustion, wear and tear through use in trade or business. (Bulletin "F," page 5.)

The 1921 law does not use the word "depreciation" at all in describing the deduction permitted under this head.

Law. Section 214 (a-8) [Individuals]; Section 234 (a-7) [Corporations]. **That in computing net income there shall be allowed as deductions:**

A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business,[2] including a reasonable allowance

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[1] For summary of definitions of depreciation, see *Depreciation, Principles and Application* (1922 edition), by Earl A. Saliers, page 9 *et seq.*

[2] **[Former Procedure]** 1913 law. (Individuals) Section II B, Sixth. "A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business."

(Corporations) Section II G (b). "A reasonable allowance for depreciation by use, wear and tear of property, if any."

for obsolescence. In the case of such property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913; . . . .

The last sentence quoted above was added in the 1921 law.

LAW. Section 215 (a) That in computing net income no deduction shall in any case be allowed in respect of—

[Individuals] (2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made;[3] . . . .

The limitation on deductions by corporations (section 235) is the same as for individuals stated in section 215 quoted above.

In the regulations of the Treasury depreciation "applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the property becoming inadequate to the growing needs of the business."[4] What may be termed ordinary obsolescence will be discussed in this chapter. Separate chapters in this book are devoted to extraordinary obsolescence and to depletion.[5] It will be clear from the context whether depreciation is used in the inclusive or in the restricted sense.

Depreciation is often treated as though no accurate esti-

1916 law. (Individuals) The words "or trade" were added.

(Corporations) The words "actually sustained and charged off" were inserted.

The 1917 law made no change.

1918 law. Section 214 (a-8). "A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence."

Section 234 (a-7) for corporations reads exactly the same as for individuals.

[3] Subsections (2) and (3) are substantially the same as in the 1913, 1916, 1917 and 1918 laws.

[4] Art. 162. Art. 159 of Reg. 33, 1918, differentiated depreciation from "depletion, obsolescence and other losses."

[5] See Chapter XXXVII, "Deductions for Obsolescence," and Chapter XXXVIII, "Deductions for Depletion."

mate of the life of assets were possible, with the result that in some cases excessive reserves, and in other cases no reserves at all are created. Perhaps the controlling reason for this variation of practice is a desire to utilize this as an elastic factor to bring about a desired effect on the balance sheet and the profit and loss statement. In some cases it is also felt that excessive book valuations may favorably affect the insurance adjustment in case of fire, but this fallacy is gradually losing ground. The recent improvement in methods of allowing for depreciation can be traced in large part to the installation of cost systems, which have brought about an increasing recognition of this factor as a necessary cost of production. Another powerful influence in the direction of accurate and adequate reserves has been the enactment of federal and state income and other tax laws calling for returns of net profits. Altogether there has in recent years been a general awakening to the fact that depreciation is a vital issue in correct accounting.

There are still wide differences of opinion as to the amount of the allowance which should be made from time to time. Net profit means only one thing in the vocabulary of the professional auditor—a meaning which should be universally recognized—and that is the excess of income over operating costs, expenses and losses. It cannot be determined by taking into account all the income and a part only of the charges against income. Full provision for depreciation must be included among the costs of operation, or the result may not be accepted as representing net profit. Statements, sometimes encountered in published reports, to the effect that a corporation has realized net profits amounting to a certain sum and that out of these profits an allowance for depreciation has been made are both misleading and illogical.

It is an unfortunate fact that the efforts of accountants to secure the establishment of proper depreciation reserves have in some respects been retarded and hampered by the attitude of certain inspectors in the administration of the income

tax law. Part of the difficulty has been due to a mistaken general policy on the part of the government in favor of strict limitations on depreciation. In the first place, reserves for this purpose, if found in the future to be too large, will be ultimately taxable for any excess, and, in any case, the government cannot afford in the long run to ignore sound economic principles in determining net income. Perhaps the greatest share of the trouble is due to the action of incompetent inspectors who sometimes arbitrarily insist upon a reduction of reserves to insufficient amounts. Fortunately their action is rarely sustained by the officers of the Treasury, whose recent attitude in the matter of depreciation and depletion has been in accord with good accounting practice.

Applicability of rates of depreciation used in prior years.— Taxpayers who use substantial rates of depreciation have sometimes been embarrassed by examiners who applied the rates used in 1917 and 1918 to their plant accounts for many years prior. In some cases this application of the rates practically wiped out the plant account as at January 1, 1917, (except for the additions of the years immediately preceding) and thus greatly reduced the allowable invested capital for excess and war profits purposes.

Such a method, of course, is inaccurate and falls of its own weight. In most cases it is possible to prove that on January 1, 1917, the actual value of the plant, without taking appreciation into consideration, greatly exceeded the theoretical valuation. Such result does not in itself prove that because the rates are incorrect as applied to prior years they are also incorrect as applied to 1917 and 1918.

The rates are incorrect as applied to prior years because during those years the renewals, repairs, maintenance and capital outlays charged to operations greatly reduced the reserve necessary to reflect accurately the net going value of the plant on the books of account.

One concern charging high depreciation rates for 20 years

prior to 1917 might show the same net plant values at the end of the period as a concern which charged off no depreciation, as such, during the entire period.

The *La Belle Iron Works* decision[6] clearly holds that taxpayer's actual investment at January 1, 1917, is the proper measure of invested capital, irrespective of book entries.

During the past year the Treasury has recognized that the practice of examiners in revising depreciation allowances set up on taxpayer's books or of making purely theoretical allowances where specific depreciation allowances had not formerly been set up as such in the taxpayer's accounts, was an improper act, and that the plant values at January 1, 1917, should, with respect to depreciation accrued prior to that date, be accepted as they appear in the taxpayer's books unless the revenue agents can produce affirmative evidence that the book values of plant are in excess of their actual value at the beginning of the taxable year.[7] Prior to the enactment of the 1917 law, it made little difference to many concerns, from a tax point of view, what rates of depreciation were charged. Furthermore, during 1917 and 1918 there were good reasons for greatly increasing depreciation rates over those formerly used.

Taxpayers whose accounts are being examined should give careful attention to the actual conditions during 1917 and 1918 and when special depreciation was warranted by existing conditions, as compared with previous practice, they should insist on proper allowances.

Conditions Precedent to Allowance for Depreciation

The general provision in the regulations which sets forth the conditions which must be met before a deduction for depreciation is allowed reads as follows:

REGULATION. A reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business

[6] 256 U. S. 377, 65 L. Ed. 998, 41 Sup. Ct. 528.
[7] A. R. R. 747, quoted in full, *Income Tax Procedure*, 1922, pages 1589-1597.

may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate) by which the aggregate of such amounts for the useful life of the property in the business will suffice, with the salvage value, and having due regard for expenditures made for current upkeep, at the end of such useful life to provide in place of the property its original cost (not replacement cost), or its value as of March 1, 1913, if acquired by the taxpayer before that date. . . . . (Art. 161.)

"Useful life," as used in the above regulation, has been interpreted by the Treasury to mean "the period of time over which an asset may be used for the purpose for which it was acquired." (C. B. 4, page 178; O. D. 845.)

It is proper that taxpayers should adopt a consistent plan and they should adhere to it until actual conditions call for a change. If it is calculated that machinery depreciates a given percentage under certain conditions, it is not inconsistent to change the percentage when conditions change.

Property depreciated must not be for personal use.—

Regulation. . . . . The deduction of an allowance for depreciation is limited to property used in the taxpayer's trade or business. . . . . (Art. 162.)

In the case of the farmer the regulations expressly permit depreciation on all farm buildings "other than a dwelling occupied by the owner."[8]

Depreciation of residence.—When a residence is used part of the year by the owner and is rented for part of the year, depreciation will be an allowable deduction for the period of the year when used for income-producing purposes. The depreciation is not necessarily based on the proportion of time

[8] Art. 171; see Chapter XLIV.

during which the property is rented, because the actual depreciation during such time may be greater than during the time of occupancy by the owner. If the taxpayer owns a summer cottage and rents it for three months during the summer and occupies it personally during one month, it may be that the entire annual depreciation should be deducted since the facts would indicate that the property as a whole is held for income-producing purposes and that the occupancy by the owner for a short period is merely incidental. The test, however, would be the actual circumstances in each case.

Regulation. . . . . No such allowance may be made in respect of . . . . a building used by the taxpayer solely as his residence, nor in respect of furniture or furnishings therein, personal effects, or clothing; . . . . (Art. 162.)

Residence used partly for business—or sublet.—

Ruling. If a portion of the residence is used for business purposes, as in the case of a physician or any other professional man who has his office in his home, a proportionate part of the depreciation sustained may be deducted, the amount to be based generally on the ratio of the number of rooms used for business purposes to the total number of rooms in the building. The same principle is applicable if a taxpayer rents a portion of his personal residence to other individuals. Under such conditions, however, the taxpayer must include in his gross income any amounts received as rentals. A taxpayer who is not allowed a deduction for depreciation of his personal residence may, in case he sells the property, disregard depreciation in computing any taxable profit derived from the transaction.

If a taxpayer owns residential property and rents it to other individuals, he is entitled to a deduction for depreciation of the rented property even though the property is not used in his principal trade or business but must include in gross income the entire amount received as rentals. (Bulletin "F," pages 7 and 8.)

"Cost" of residence is not reduced by depreciation.—

Ruling. Inasmuch as no deduction for depreciation of the personal residence of a taxpayer is allowable in his income tax returns, a taxpayer in determining the gain or loss arising from the sale of his personal residence, continuously occupied by him as such, is not required to reduce the cost of the property or its fair market value

as at March 1, 1913, by the depreciation sustained. (C. B. 3, page 46; O. D. 600.)

Property which may be depreciated.[9]—

Regulation. The necessity for a depreciation allowance arises from the fact that certain property used in the business gradually approaches a point where its usefulness is exhausted. The allowance should be confined to property of this nature. In the case of tangible property, it applies to that which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence due to the normal progress of the art, as where machinery or other property must be replaced by a new invention, or due to the property becoming inadequate to the growing needs of the business. It does not apply to inventories or to stock in trade, nor to land apart from the improvements or physical development added to it. It does not apply to bodies of minerals which through the process of removal suffer depletion, other provisions for this being made in the statute. . . . . (Art. 162.)

Potential earning power not subject to depreciation.—

Ruling. The potential earning capacity of an individual, his inventive genius or his literary ability may not be made the basis of an allowance for depreciation. (Bulletin "F," page 6.)

Replacements and renewals must not be twice deducted.— Expenditures for the upkeep of property range by imperceptible gradations from the most insignificant repairs to the replacement of the largest and most costly units. The law, of course, intends that all such expenditures shall be deducted, but the necessity arises of distinguishing between those which shall be deducted annually as expenses and those for which provision shall be made through cumulative depreciation allowances. In making this distinction, care must be taken to avoid the double deduction of expenses. The problem is complicated by the fact that minor repairs are made upon the most expensive machines. While theoretically it may be conceivable that depreciation rates might under some conditions be so

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[9] For depreciation of land, see page 1040. For depreciation of farm buildings, equipment and livestock, see Chapter XLIV.

delicately adjusted as to provide completely and perfectly for the entire upkeep of a machine or other piece of property, as a practical matter it is so difficult as to be impossible. The accountant's solution is to draw a somewhat arbitrary line between the small incidental items of repair, replacement and maintenance and the heavy items of renewal and replacement, charging the first group to expense and the second to depreciation reserves. The depreciation rates are calculated with this assumption in mind and consequently depreciation reserves should be kept free from charges except those for unquestioned renewals or replacements of major parts. The regulations satisfactorily cover this point in the following statement.

Regulations. . . . . Property kept in repair may, nevertheless, be the subject of a depreciation allowance. . . . . (Art. 162.)

The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve if such account is kept. . . . . (Art. 103.)

The Treasury in its latest rulings recognizes the necessity for proper repair and depreciation charges.

Ruling. Accordingly, amounts paid for repairs are not allowable deductions if they are duplications of allowances for depreciation. It does not follow, however, that there may not be in the same case allowable deductions both for depreciation and payment for repairs. As a rule, property that has been subject to use even though maintained in serviceable condition by repair has a shortened expectancy of usefulness. In such case there may be a deduction for payments for repairs and also a deduction for loss due to depreciation of the property which occurred despite the maintenance of such property in repair. (Bulletin "F," page 29.)

Closely related to this question is the treatment of expenditures for making improvements. This is discussed in the following decision of a United States Circuit Court which

holds that improvements which are not permanent in character are deductible as expense:

DECISION. (Syl.) Amounts expended by a business corporation in enlarging or making improvements in its office or premises, not in the nature of permanent improvements to the property, but to facilitate the transaction of a growing business, should properly be deducted as necessary expenses of the business. (*Connecticut Mutual Life Insurance Co. v. Eaton,* 218 Fed. 206.)

The principle outlined in the law and regulations appears to be clear, but considerable difficulty has arisen in its application because of the refusal of revenue agents to allow in some cases for both repairs and depreciation, on the ground that the former includes the latter. The practice is not uniform, the revenue agents frequently differing in their interpretation of charges which may be either repairs or renewals. Naturally, they incline to the conclusion that where there is a doubt, the expenditure is a charge against the reserve, but good business practice requires that in case of doubt the repairs be charged to operating expenses. The true issue is merely the avoidance of a double charge against income.

Some manufacturing plants and mills produce in their own shops various parts of looms and other machines used to manufacture the principal products of the mills. These parts range from the largest to the smallest unit of each machine, so that over a period of years the looms are continually being renewed, particularly where the policy of the mill management is to maintain the plant at the peak of operating efficiency.

In such cases complete analyses of the cost records should be kept in order to distinguish replacement items from those which are "incidental repairs."

DEPRECIATION OF LEASED MACHINERY.—

RULING. The M Company owns certain apparatus which it leases under contracts for a period of years at an agreed rental. The contracts provide that the lessor shall maintain the apparatus for the period of the contract without charge to the lessee and that the apparatus shall remain the property of the lessor. Although the apparatus is of some value at the expiration of the lease, such value is

less than the cost of its removal and it is therefore abandoned by the lessor at the expiration of the lease.

The expenditure for labor incident to the installation of the apparatus, being possible of allocation thereto, and the cost of the material entering into the installation are held to be capital expenditures, recoverable through depreciation spread over the term of the original lease. If the apparatus had a salvage value at the expiration of the lease it would be necessary to take this value into consideration in computing deductions for depreciation as provided in article 161 of Regulations 45. (C. B. 5, page 175; O. D. 1082.)

The costs of maintaining the apparatus under the terms of the contract are, of course, chargeable against current income.

Depreciation of railway roadway offset by maintenance and appreciation.—In a recent case,[10] the court held that no deduction for depreciation in value of the roadway of a railroad may be taken where, because of repairs, renewals and replacements, the roadway as a whole is as valuable at the end of the taxable year as at the beginning.

The foregoing decision accords neither with good accounting principles, nor with the position of the Treasury. The case was brought under the 1909 law and may not be considered as a precedent for procedure under subsequent laws. It is inserted at this point as an illustration of the uncertainty of court decisions.

Certain repairs are properly capital expenditures.—Although it is an accepted rule that repairs and all other expenses of maintenance should be charged against profit and loss, an exception to this rule is found in cases where partly worn-out or run-down plants are purchased with the intention on the part of the new owners to rehabilitate them so that they can be operated efficiently. It may be assumed that the purchase price takes the poor condition of the plant into consideration, in which case the entire cost of repairs and renewals may properly be capitalized.

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[10] *Nashville, Chattanooga and St. Louis Ry. Co. v. U. S.*, 269 Fed. 351; certiorari denied, 255 U. S. 569, 65 L. Ed. 790, 41 Sup. Ct. 375.

REGULATION. Amounts paid for increasing the capital value or for making good the depreciation (for which a deduction has been made) of property are not deductible from gross income. . . . . (Art. 293.)

If the replacements are of a *permanent* nature they are chargeable to capital.[11]

Depreciation must be entered upon the books of a corporation.—Neither the 1921 nor the 1918 law specifies that depreciation must be charged off on the books of an individual or a corporation,[12] but in other sections of the law the Commissioner is given ample power to enforce proper accounting methods. It may be assumed, therefore, that all corporations and all individuals who keep books must enter depreciation on their books, or it will not be allowed as a deduction. The restriction is a proper one.[13] The author has no sympathy for any corporation which is not willing to have its income tax returns agree with its books. The following regulation deals with this point:

REGULATION. A depreciation allowance, in order to constitute an allowable deduction from gross income, must be charged off. The particular manner in which it shall be charged off is not material, except that the amount measuring a reasonable allowance for depreciation must be either deducted directly from the book value of the assets or preferably credited to a depreciation reserve account, which

[11] Bulletin "F," page 29.

[12] See page 998.

[13] [Former Procedure] Such a restriction upon corporations was contained in section 12 (a), second, of the 1916 law.

The 1913 law contained no such provision, but the Treasury nevertheless ruled that "in order to be allowable . . . . the loss . . . must be so entered upon the books of the company as to constitute a liability against its assets." (Letter to collectors, August 27, 1914.) This ruling, while it did not follow the law, conformed to correct accounting. Accurate accounting requires that depreciation be shown on the books, but the mere existence of the book record does not make actual depreciation more or less. The courts rightly took the position that if a definite, easily proven diminution of value had occurred, the mere non-entry of it on books of account could not possibly serve to negative the fact. As in so many other matters, the Treasury was inconsistent in its ruling on the book record of depreciation, because, in general, it took the proper position that book records are subordinated to facts, while in this respect its position was that the fact is subordinated to the book record.

must be reflected in the annual balance sheet. The allowances should be computed and charged off with express reference to specific items, units, or groups of property, each item or unit being considered separately or specifically included in a group with others to which the same factors apply. The taxpayer should keep such records as to each item or unit of depreciable property as will permit the ready verification of the factors used in computing the allowance for each year for each item, unit, or group. (Art. 169.)

Banks may keep additional records for depreciation purposes.—

Ruling. Held, that where banks under Federal or State statute are required to submit periodically to the Comptroller of the Currency or to the State Banking Commissioner a statement of financial condition, additional records and books may be kept which reflect the correct investment account and net income for income and excess profits tax purposes and that any adjustments made thereon with respect to the banking house furniture and fixtures, depreciation, etc., should be accepted as meeting the requirements of the law and regulations for income and excess profits tax purposes. (C. B. 4, page 64; Digest A. R. R. 377.)

It was the purpose of A. R. R. 377 (C. B. 4, page 64) to permit National banks and State banks the use of a supplemental set of books or records in which the correct investment, net income, and any adjustments with respect to banking house furniture and fixtures and depreciation, etc., could be entered. . . . . (I-30-424; Digest A. R. M. 172.)

The reason for these rulings is that the statements rendered to the federal or state authorities frequently include adjustments, for instance, the writing down of investments to market values or the inclusion in expenses of additions to the banking house or its equipment, which are not permissible for income tax returns.

Only charges applicable to current year deductible.—Recent rulings have now settled beyond question the principle that only those depreciation charges which are properly applicable to the current year may be deducted in that year, and any readjustment must be made by filing amended returns (see page 1011).[14]

[14] C. B. 4, page 180; O. D. 948. Bulletin "F," page 35.

A regulation[15] makes specific provision for an alteration in the rate of depreciation in cases where the life of the property has been underestimated, but does it, not by reconstructing the entire depreciation history of the property with readjustments in the returns for previous years, but rather by distributing the remaining portion of the value not covered by depreciation over the estimated remaining life of the property. It would seem that the converse of this would also apply, viz., that if the life of the property was overestimated, the rate of depreciation should be increased during the remaining years of its life sufficiently to cover the loss.

Good accounting practice requires that lump sum purchases be segregated on the books of account. It is better to open too many accounts than too few, because experience demonstrates the fact that depreciation is more easily ascertained by the use of a number of ledger accounts than when undivided property or plant accounts are kept.

When it is impossible definitely to allocate the cost, it should be prorated on some equitable basis or by a new appraisal made as of date of acquisition.

Amended returns may be necessary.—It may be necessary to prepare amended returns from 1913 to the time when the adjustments are made. If the amount involved is substantial there is no other way of correcting the former erroneous practice.

The regulations are fair and reasonable in that taxpayers are required to make each year's returns include accrued depreciation for only one year. The adjustment of accounts will work out to the advantage of the government and to the disadvantage of the taxpayer if the depreciation allowance is decreased during a period of high taxes and *vice versa.* But taxpayers should keep in mind that actual depreciation, in almost all cases, was far greater during the years 1917 and 1918 than during the pre-war period.[16]

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[15] Art. 166; see page 1025.
[16] See pages 1002 and 1024.

Amended returns acceptable to Treasury.—If original returns were made in good faith, they may be corrected if found to be erroneous.[17]

Depreciation should be based on cost or value March 1, 1913.—The 1921 law specifically provides that in the case of property acquired before March 1, 1913, the value as of that date is the proper basis for estimating depreciation. If the property was purchased after March 1, 1913, the cost of the property is the basis for computing depreciation. In the case, however, of property received as a gift after March 1, 1913, and before December 31, 1920, depreciation is based on the fair market value of the property at the time of the gift.[18]

Regulation. The capital sum to be replaced by depreciation allowances is the original cost of the property in respect of which the allowance is made, except that in the case of property acquired by the taxpayer prior to March 1, 1913, the capital sum to be replaced is the fair market value of the property as of that date. In the absence of proof to the contrary, it will be assumed that such value as of March 1, 1913, is the cost of the property less depreciation up to that date. To this sum should be added from time to time the cost of improvements, additions and betterments, the cost of which is not deducted as an expense in the taxpayer's return, and from it should be deducted from time to time the amount of any definite loss or damage sustained by the property through casualty, as distinguished from the gradual exhaustion of its utility which is the basis of the depreciation allowance. . . . . (Art. 164.)

This rule, of course, departs somewhat from the usual accounting procedure because of the insertion of March 1, 1913, as the date for establishing a value for purposes of depreciation. The ordinary practice is to take original cost, determine a liberal depreciation rate and, when the reserve equals the original cost, discontinue depreciation.[19] However,

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[17] Bulletin "F," pages 33-34.

[18] See page 1017.

[19] **[Former Procedure]**

Ruling. Prior to the approval of Treasury Decision 2754 (August 23, 1918) depreciation allowances were required to be based on the cost of the property. This Treasury decision authorized depreciation deductions based on the value of property as of March 1, 1913, if acquired prior thereto.

the 1913 value is not taken as a basis in the case of leaseholds (see T. D. 3414, quoted on page 1043).

If March 1, 1913, value was substantially in excess of the cost less depreciation to that date, amended returns for subsequent years embodying revised depreciation allowances would be in order.

FUTURE REPLACEMENT COST NOT A FACTOR.—

RULING. Replacement value of property can not be substituted for the cost of the property as the cost of replacement at a time some years in the future is a speculative figure which can not be used as a basis for determining an annual depreciation charge. . . . . (C. B. 1, page 138; O. D. 283.)

DEPRECIATION COMPUTATION IN CASE OF REORGANIZATIONS.—

RULING. . . . . The fair market value of the assets as of the date of liquidation of the corporation will be held to be the cost of the assets to the stockholders who, as partners, turned the assets over to the partnership, and will be the basis for determining the depreciation allowance to be claimed each year with respect to such assets. . . . . (C. B. 3, page 170; O. D. 639.)

The foregoing ruling is based upon the principle of a "closed transaction." If a transfer of title constituted a "continuing" transaction, this change in the depreciation base would not be permitted.[20]

Under the 1921 law stockholders are permitted to treat the securities of a new or reorganized company as taking the place of the old.

When the stockholders of the new corporation are precisely the same as the old, it would not appear that the depreciable assets on the new books should be set up for depreciation purposes at values in excess of those on the old

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The basis in the case of property acquired on or after that date remained unchanged.

In an opinion rendered by the Solicitor of Internal Revenue it was held that Treasury Decision 2754 is applicable to returns for 1913 and all subsequent years. (Bulletin "F," page 19.)

[20] For discussion of what constitutes a "closed transaction," see Chapter XXI.

books. When the new stockholders are not the same, the situation is different, as such new stockholders may have bought into the company on the basis of the present actual value of the assets and therefore are entitled to depreciation based on such full values. There is nothing in the law which prevents the purchasing or reorganized corporation from setting up all of the assets at full value. In the absence of an inhibition against it, the new corporation as a separate entity would seem to be entitled to get back such capital value through depreciation.

When assets are transferred, care should be taken to transfer them at gross book value and not after deducting any reserve that may have been set up on the books of the old firm. In some cases revenue agents have computed depreciation on such net figures at the old rates. This of course results in much smaller depreciation deduction for the taxable year of the new concern. If the net value of the assets is used, the rate of depreciation should be increased to reduce the assets to salvage value at the end of their useful life.

Revaluation as of January 1, 1909, applicable to corporation excise tax only.—In all cases relating to depreciation during the period January 1, 1909, to February 28, 1913, the fair value of property at January 1, 1909, is still a factor.

As to 1913 and subsequent years, both for the purpose of determining taxable profits on sales and allowances for depreciation, corporations may revalue their assets as of March 1, 1913, whether or not a similar revaluation was made at January 1, 1909. If the value at March 1, 1913, was in excess of the January 1, 1909, valuation, no tax is imposed thereon even though realization takes place after March 1, 1913.

Assets revalued on a corporation's books as of January 1, 1909, in an amount in excess of the book value at that date, revalued again as of March 1, 1913, in an amount in excess of the January 1, 1909, valuation and sold since March 1, 1913,

at a still greater value, will be taxable only on the difference between the March 1, 1913, value and the price realized.

No tax on appreciation can now be collected under the 1909 law, and no tax can be collected under the 1913 and later laws on any appreciation which accrued prior to March 1, 1913.[21]

Depreciation of depreciable and non-depreciable property acquired after March 1, 1913.—

REGULATION. . . . . In the case of the acquisition on or after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump price, as, for example, land and buildings, the capital sum to be replaced is limited to that part of the lump price which represents the value of the depreciable property at the time of such acquisition. . . . . (Art. 164.)

When depreciation deduction results in deficit.—

RULING. Corporate taxpayers in some cases compute their net income for the taxable period without having made allowance for depreciation and then distribute the entire net income so computed to their stockholders so that the books show no surplus or undivided profits. In such cases if a corporation subsequently desires to avail itself of the privilege of deducting an allowance for depreciation in its return for such taxable period it must first reopen its books and make the appropriate charges. . . . . It will then be placed in the position of having paid a dividend from a depreciation reserve or from capital to the extent that the amount of dividend paid exceeds the true net income, meaning the net income *after* making proper charges for depreciation. The amount of the excess will be deemed a distribution in partial liquidation and taxed accordingly to the stockholders. . . . . [22] (Bulletin "F," page 35.)

When the depreciation deduction is in excess of the net earnings, a net loss results which under the 1921 law may be carried forward to a subsequent year.[23]

Depreciation in cases of permanent discontinuance.—

REGULATION. If the use of any property in the business is permanently discontinued, although no sale or other disposition of the

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[21] For discussion of taxability of dividends paid from realized appreciation, see page 712 *et seq.*

[22] See also C. B. 4, page 180; A. R. M. 112 and I-36-494; I. T. 1440.

[23] Net losses are discussed on pages 965-975.

property has taken place, a determination of any gain or loss may be made; but any deduction in respect of any loss thereon must be disclosed in the taxpayer's return for the year in which the determination is made and a full statement of the facts and the basis upon which the computation is calculated must be attached to the return. Upon a sale or other disposition of the property, the consideration received shall be compared with the amount of the estimated salvage value used in computing the gain or loss as above provided, and the amount of the difference shall be treated as a gain or loss, as the case may be, of the year in which the sale or other disposition was made. . . . . (Art. 170.)

A loss arising from discontinuing the use in business of depreciable property may be due to obsolescence. That subject is discussed in Chapter XXXVII.

DEPRECIATION OF PROPERTY INVOLUNTARILY CONVERTED.—

RULING. A building, the book value of which was $10x$ dollars, was destroyed by fire. This building was replaced by a new structure at a cost of $20x$ dollars, the amount received from the insurer.

Since the entire proceeds from the involuntary conversion of the old building were invested in the new building, the new building shall be considered as taking the place of the old and the basis for the depreciation of the new building will be the cost of the old, or, if acquired prior to March 1, 1913, its fair market value as of that date, less depreciation sustained and allowable as a deduction. The new building should be depreciated over its estimated useful life. (I-32-449; I. T. 1413.)

The subject of involuntary conversion of property and replacement thereof is treated in Chapter XVIII.

Depreciation claimed by fiduciaries and beneficiaries.— The procedure is prescribed by the Treasury as follows:

RULING. An individual who receives income from a trust estate may not deduct from gross income in his individual income tax return any amount representing depreciation of property belonging to the estate. However, under the Revenue Act of 1918 it is permissible for the fiduciary in ascertaining the net income of the estate or trust for which he acts to deduct a reasonable allowance to cover the depreciation sustained during the taxable year, whether or not the terms of the will or agreement creating the estate or trust or a decree of court provide for taking care of the depreciation which may be sustained on the property held in trust.

Estates and trusts are under certain circumstances treated as a unit, and in other cases may represent an aggregate of distinct interests to all of which the fiduciary is responsible. Irrespective of whether the estate or trust is or is not treated as a unit, the fiduciary in computing the net income upon which he is required to pay the tax may claim a deduction for depreciation. . . . [24] (Bulletin "F," pages 32-33.)

Depreciation of property acquired by gift.—

RULING. If a taxpayer acquires depreciable property by gift, bequest, or devise, and uses it for purposes of trade or business, he is entitled to a deduction from gross income for depreciation of such property. . . . the deduction is based on the fair market price or value of the property at the date when acquired, or if acquired prior to March 1, 1913, its fair market price or value as of that date. . . . (Bulletin "F," pages 9 and 19.)

The foregoing applies to property acquired by gift before December 31, 1920.

Section 202 (a-2) of the 1921 law provides that for the purpose of computing gain or loss on subsequent sale, property acquired by gift after December 31, 1920, is to be deemed to have the same cost or March 1, 1913, value (if acquired prior thereto) as if still in the hands of the donor.[25] The question arises as to what value the donee should use for depreciation purposes in case the gift consists of depreciable property. The donee might conceivably use one of two values:

(a) Value at date of gift.
(b) Cost to donor or March 1, 1913, value if acquired by the donor prior thereto.

In case (a) the donee would be basing depreciation on an appreciated or depreciated value as compared with the cost to the donor which, under section 202 (a-2) is now assumed to be the cost to the donee. It would seem that if (b) is to be the basis on which the donee must compute gain or loss in case of sale, the Treasury will use the same basis for depreciation purposes.

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[24] See discussion of depreciation allowances to beneficiaries, and as between life-tenant and remainderman, Chapter XLII.

[25] See page 618.

Depreciation divisible between joint owners.—

Ruling. A joint owner of inherited property, collecting rents and profits from such property and managing the property on behalf of all the owners, pursuant to an oral agreement, is an agent and not a fiduciary. It is, therefore, necessary for each of the joint owners to file an income tax return and account for his share of the income from the property in addition to income received by him from other sources. In preparing such returns each joint owner may claim as a deduction for each year his proportionate share of the depreciation allowance for such year with respect to the property held in joint ownership.[26]

Reserves for Depreciation

According to the regulations the particular manner in which the depreciation allowed as a deduction pursuant to the law is entered on the taxpayer's books, is not material except that the amount "must be either deducted directly from the book value of the assets or preferably credited to a depreciation reserve account, which must be reflected in the annual balance sheet."[27]

Use of depreciation reserves.—The Treasury no longer holds the very narrow view it once held as to the investment of depreciation reserves in the taxpayer's own plant.

The amounts reserved for depreciation need not be specifically invested.[28]

Rates of Depreciation—General

The law in regard to rates specifies merely that the depreciation allowances shall be "reasonable," and the Treasury very sensibly makes no attempts to fix specific rates which shall be considered satisfactory.

Regulation. The capital sum to be replaced should be charged off over the useful life of the property either in equal annual installments or in accordance with any other recognized trade practice, such as an apportionment of the capital sum over units of produc-

[26] Bulletin "F," page 33.
[27] Art. 169; see page 1009.
[28] Bulletin "F," page 34.

tion. Whatever plan or method of apportionment is adopted must be reasonable and must have due regard to operating conditions during the taxable period. While the burden of proof must rest upon the taxpayer to sustain the deduction taken by him, such deductions must not be disallowed unless shown by clear and convincing evidence to be unreasonable. The reasonableness of any claim for depreciation shall be determined upon the conditions known to exist at the end of the period for which the return is made.[29] (Art. 165.)

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[29] Methods of determining depreciation allowances:

1. The fixed percentage basis. This method is the most popular and is the one in general use. It is applied as follows:

(a) On a flat basis, e.g., if the life of a machine is ten years, one-tenth, or 10 per cent, is charged off annually.

(b) On a reducing scale basis, i.e., a rate is ascertained which, when applied to the original cost and the diminished value thereof as periodically determined, will reduce the book value to scrap value at the end of the machine's estimated life.

2. Sinking fund method. If it is proposed to set aside such a sum periodically as will equal the original cost of a machine (less scrap value) at the end of its estimated life, it is customary, after taking into consideration the average rate of interest which can be secured, to pay into a fund a fixed amount periodically. The aggregate thereof, together with the accumulated interest, will equal the amount required to renew the machine in question. This method is in practice seldom followed.

There is good authority, however, for its use where a single large piece of property, such as an office building, apartment house or ship is being operated which is eventually to be replaced.

3. Production method. A method of making depreciation allowances which has its advantages under certain conditions is that of charging an established rate per unit of output. This is especially applicable in the case of, say, a blast furnace where the frequency with which the linings will need to be renewed depends on the extent to which the furnace is being used. If it is being run at full capacity night and day, the wear on the linings is obviously much greater than if the furnace were not in continual use during the entire fiscal period.

Another species of depreciation which may be said to come under the above caption is that caused in a plant by the exhaustion of the mines or timber lands for the operation of which the plant was constructed. Most of the value of coke ovens, for instance, is gone when the mines for which they were constructed are worked out. Consequently, in determining the amount to be written off for depreciation of mining and lumbering plants, the factor of the probable future output of the mines or lands will be an important one and it will frequently be found advisable to base the plant depreciation charge on the output. Certainly this should be done where it is evident that the plant will outlive the exhaustion of the mines or lands. In such cases the depreciation charges should be sufficient to absorb the entire cost of the plant, less residual value, by the time the mines or lands are exhausted, even though at that time the plant may still be in good operating condition. Of course, any actual residual value must be considered. [*Auditing, Theory and Practice,* Vol. I (1921 edition), by R. H. Montgomery, pages 627-632.]

Ruling. In computing allowances for depreciation under the provisions of the Revenue Act of 1918, in cases in which during the taxable year improvements, additions, or betterments have been made to depreciable property or in which during the taxable year depreciable assets have been abandoned, depreciation should be computed for the entire taxable year only upon those assets which were properly included in the opening balances of the depreciable asset accounts and which were not abandoned or scrapped during the taxable year. Depreciation should be computed on each asset discarded during the year at the proper annual rate for the period from the beginning of the year to the date the asset was abandoned, and upon each improvement, addition, or betterment made during the year, the cost of which is not deductible from gross income as a business expense, at the proper annual rate for that portion of the taxable year intervening between the date the improvement, addition, or betterment was made and the close of the taxable year. It is to be understood, of course, that if in any case the improvements, additions, or betterments made or the assets discarded were, during the taxable year, so numerous and in such small amounts that the time and labor involved in computing depreciation in this manner upon each separate improvement, addition, or betterment, or asset abandoned, would be so disproportionate to the resulting change in tax liability as not to warrant depreciation being so computed, such changes in the depreciable assets may be considered to have occurred ratably during the year and the depreciation computed upon the average of the opening and closing balances of the asset account, such average being determined by adding together the balances at the beginning and end of the taxable year and dividing by 2. (C. B. I-1, page 173; Digest I. T. 1158.)

The foregoing ruling merely states the rule that depreciation can only be taken on "property used in the trade or business,"[30] and that where changes take place during the year in the amount of depreciable property, effect must be given thereto.

Depreciation methods approved by Treasury.—The Treasury has approved only two methods, but is willing to adopt other methods if they are found to be more accurate.

Fixed percentage method.—

Ruling. . . . . . The "fixed percentage" method as applied by the Commissioner contemplates that the annual depreciation deductions

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[30] Section 214 (a-8).

with respect to any property should be equal; that the rate of depreciation should be assumed to be uniform during the useful life of the property, as compared with the so-called "fractional method—weighted years," "declining balance method—scientific or unscientific," "revaluation method," and "sinking fund method," the use of which is advocated by accountants, but none of which have been approved in their entirety by the Commissioner for income tax purposes. (Bulletin "F," page 31.)

Production method.—

Ruling. The only other method which has been approved by the Commissioner is an apportionment of the depreciation charges over the total amount of work to be performed or over units of production. For example, a contractor may purchase machinery for use only in performing a certain contract, which machinery will be worthless or have little or no salvage value upon completion of the contract on which he will be engaged for the whole of one taxable year and half of the succeeding taxable year. But the number of units of work, or percentage of completion accomplished during the first period of 12 months and during the second period of six months, may be equal. The contract may call for the making of an excavation, and the same number of yards may be excavated during each of the above periods. Under such circumstances, if the contractor returns his gross income each year on the basis of percentage of completion of the contract, he will be permitted to spread the total amount of the depreciation allowance equally over the two periods, deducting half of the total amount in his return for the first 12 months, and the other half in his return for the succeeding taxable period.

If the contractor had returned his income on some basis other than that of percentage of completion of the contract, it would have been necessary for him to modify his basis for computing the depreciation allowances. Thus, if the gross income was returned on the basis of time required for completion of the above contract, two-thirds of the gross income being reported in the return for the first 12 months, and the other third reported in the return for the succeeding period; in that case two-thirds of the total depreciation allowance would be deducted in the return for the first period and the remainder in the next return. (Bulletin "F," page 31.)

The intention of the foregoing illustration is to permit an equitable deduction for depreciation. When the allocation mentioned does not work equitably, it is permissible to adopt a method which reflects the true net income for each period.

The fundamental principle underlying the production

method may be illustrated thus. If a machine is capable of producing during its useful life 100,000 units, and in one year produces 20,000 units, then 20 per cent of its cost should be charged off as depreciation in that year.

Dependence upon life of enterprise as a whole.—The "number of years constituting its life" and the permissible revaluation as of March 1, 1913, are vitally affected in the case of some types of property by the life of the enterprise in which it is used. In the case of a mine or an oil or gas well, the deposit may be exhausted before the expiration of the normal life of some of the buildings and machinery. The regulations provide that in the case of an oil or gas property the depreciation shall be such "an amount, based upon its cost (or fair market value as of March 1, 1913, if acquired prior to that date), equitably distributed over its useful life, as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired."[31] A somewhat similar provision is made in the case of mining properties[32] and timber properties.[33] In the case of a building constructed on leased land, "if the remainder of the term of lease is greater than the probable life of the building erected . . . . this deduction shall take the form of an allowance for depreciation."[34] This, of course, is basing the depreciation rate on the life of the improvement, rather than on the duration of the lease.

Ruling. Held, ... that the cost of the new boilers, less salvage value, may be recovered by annual deductions spread over the period of the estimated remaining timber supply, it being assumed that at the end of this period the cost of removing the boilers to a new timber region will be more than their worth in the new location. . . . . (C. B. 4, page 179; Digest O. D. 871.)

Enterprises affected by the close of the war.—The "useful life" of much war property did not extend beyond

[31] See Art. 225, page 1049.
[32] Art. 224; see page 1046 *et seq.*
[33] Art. 227; see page 1177.
[34] Art. 109; see page 838.

the end of the war. What is the proper term to use for the accruing expense or cost incident to idle plant? If depreciation were permitted only for wear and tear of a plant constructed to manufacture war materials, which has not been used since the war ended, the owner would be in a bad way.

Many contracts let by the government itself specifically provided for extraordinary depreciation rates to be included as part of the cost of production of war materials. The munitions tax law permitted the amortization of plants used for war purposes over the estimated war production.

The 1921 law re-enacts the provisions of the 1918 law which takes care of depreciation due to war conditions.[35] As the loss is one due to extraordinary obsolescence, the matter is fully discussed in Chapter XXXVII.

Depreciation of plant or equipment acquired before April 6, 1917, which was devoted to war purposes, is also discussed in Chapter XXXVII.

Depreciation a local issue.—The taxpayer must take local conditions into account in considering rates of depreciation. In one locality boilers may depreciate 7½ per cent annually; in another the rate may be 15 per cent; and the variation may be entirely legitimate. It is not merely a question of the quality of the boilers. No engineer or boiler manufacturer can give an intelligent estimate unless he knows the use to which the boiler is subjected, the climate, the water, the class of labor, the probabilities of shut-downs, etc. A similar situation exists in the case of almost all other classes of property which depreciate by wear and tear. Therefore, whenever rates of depreciation are mentioned in this chapter, they must be taken as suggestions only and be treated as rough approximations of what may be expected under normal conditions.

A table of depreciation rates, revised to date, applicable to specific depreciable assets, with the names of the authorities

[35] Sections 214 (a-9), and 234 (a-8).

for the rates given, may be found at the end of this chapter (pages 1066-1075).

Depreciation rate affected by "overtime" or "overload."— When machinery is run "overtime" there is little opportunity properly to repair and maintain the machines. Moreover, a two-shift system means divided responsibility, and with divided responsibility the machinery is sure to suffer. New workmen and those on night duty are often less efficient than the regular staff and there is a consequent ill effect upon the machines.[36] In spite of all this some revenue agents have been reluctant to allow special depreciation when a plant was being run "overtime." Consequently the following is of great interest:

> RULING. It is recognized also that property, for example, manufacturing machinery, may be subject to extraordinary depreciation due to being operated overtime, at an overload, or being used for some purpose for which it is not adapted. Under such conditions, a taxpayer may deduct in addition to the amount measuring the depreciation under normal conditions, a further sum to provide for the extraordinary depreciation. It does not necessarily follow that if a machine operated normally for 8 hours a day, is operated for 16 hours a day, it will depreciate twice as rapidly as when operated under normal conditions. The estimate of the extraordinary depreciation should be made by the taxpayer according to his judgment and experience and will be subject to the approval of the Commissioner. (Bulletin "F," page 27.)

When normal rates of depreciation were 7½ per cent per annum, the British War Ministry suggested the following additions:

Addition for unskilled labor up to 50%	3¾%
Addition for overtime	11¼
Total additions	15%
Normal rate	7½
Total	22½%
Maximum allowance	25%

The United States War Department Engineers suggested 15 per cent as a maximum.

[36] See also page 1002.

Adjustment of rates used in former years.—The author believes that deductions for depreciation claimed and allowed in returns during the years preceding the taxable year should be reopened only under special conditions. Corporations and individuals subject to the taxes in force during those years were on notice from the government as to the basis of the allowable deductions and were also on notice from accountants and bankers that proper provision for depreciation should be made. What was done at the time, while the facts were fresh in mind, should stand unless an explainable mistake was made. Depreciation rates should be neither played with nor juggled. The rates of an income tax should not (because they *do not*) determine depreciation rates. Unless the Commissioner is convinced that a meritorious case exists, he should not permit amended returns to be made.

When, however, it is discovered that depreciation was incorrectly calculated to a substantial amount in prior years, it is not good accounting practice to make the adjustment in the taxable and subsequent years. It is not fair either to the government or to the taxpayer.

Regulation. If it develops that an error was made in estimating the useful life of the property, the plan of computing depreciation should be modified and the balance of the cost of the property, or its fair market value as of March 1, 1913, not already provided for through a depreciation reserve or deducted from book value, should be spread over the estimated remaining life of the property. Inasmuch as under the provisions of the income tax acts in effect prior to the Revenue Act of 1918 deductions for obsolescence of property were not allowed except as a loss for the year in which the property was sold or permanently abandoned, a taxpayer may for 1918 and subsequent years revise the estimate of the useful life of any property so as to allow for such future (not past) obsolescence as may be expected from experience to result from the normal progress of the art. . . . . (Art. 166.)

Under the foregoing regulation, obsolescence which has not been absorbed in depreciation charges, and which is acknowledged to have "accrued" prior to 1918, can never be deducted. For discussion see Chapter XXXVII.

Excessive rates—negligence not imputed.—

Ruling. . . . . if understatements of taxable net income in returns are due to charging off depreciation in excess of an amount deemed reasonable by the Commissioner, negligence or intent to defraud will not be imputed to the taxpayer unless the position taken is so unreasonable as to indicate gross carelessness or bad faith. . . . . (Bulletin "F," page 27.)

Special depreciation of excessive costs.—Ample provision has been made for special depreciation of plants and equipment constructed or purchased "for the production of articles contributing to the prosecution of the present war."[37] The question arises as to what provision, if any, has been made for plants which cannot qualify in the war work class.

Commencing in 1915, almost all classes of materials advanced in price until the cost of erecting and equipping a plant was perhaps double what it had been before the war.

For example, take a plant which cost a million dollars to build and equip in 1913. The plant is duplicated in 1918 at a cost of two millions. What rates of depreciation shall be charged during 1919 on the two plants? If the proper average rate on the old plant is 8 per cent, is that the proper rate on the new plant? Is $160,000 per annum for the new plant the equivalent of $80,000 for the old plant? Strictly speaking, it is equivalent because depreciation rates, when accurate, are based on the effective life of the plant, and if reserves at the rate of 8 per cent per annum will provide a fund sufficient to recoup the cost of the plant as it wears out, no higher rate is permitted under a strict interpretation of the existing law.

There is, however, a sound foundation for a claim to extra depreciation on the part of those who have erected plants during this period of high prices, even when the plant did not become obsolete after the close of the war.[38] It can be assumed that anyone who built a plant under the conditions which have

[37] See Chapter XXXVII.

[38] See Chapter XXXVII. For a discussion of the use of replacement funds in the case of losses through war hazards, see Chapter XVIII.

existed during the recent past did so because he counted upon being able, through the profits of this abnormal period, to write off that part of the cost of the plant which was clearly supernormal so that he might be on the same cost basis after the return of peace as the proprietors of other plants built before or after the period of very high prices.

The foregoing argument must not be construed to support increases in current depreciation rates where the cost of the property involved was normal although recently purchased, nor in any case where the property was acquired prior to 1915.

Depreciation of plant or equipment acquired before April 6, 1917.—The foregoing comments refer in general to all classes of plant and equipment no matter when purchased. The 1921 law re-enacts the provisions of the 1918 law which provide full relief for losses on plant and equipment acquired after April 6, 1917; but no special relief for losses arising out of the subsequent fall in value of property acquired at the high prices which prevailed after 1915 and before April 6, 1917, is found in the law. The Commissioner, however, may hold that a reasonable allowance for depreciation as applied to special conditions means a higher allowance than under ordinary conditions.

It is safe to assume that almost all plants erected during 1916 and early in 1917 were operated under adverse conditions and that the actual depreciation which took place was probably double the normal depreciation.

Depreciation Rates and Practice—Specific Suggestions

In the pages which follow, information is given which is intended to serve as a guide in deciding in what cases and at what rates depreciation shall be charged. The topics, which are arranged in alphabetical order, deal in some cases with specific objects or classes of objects, and in other cases with types of enterprises. The list is not intended to be and obviously cannot be complete. The variations of the rates in

some of the cases given indicate the futility of trying to set uniform rates applicable to given objects under all conditions.

The theory of depreciation is that there should be a return of the investment by the end of the useful service life of the asset. The rate should be fixed accordingly.

Alterations and improvements.—In some cases alterations are charged as an expense, being regarded as in the nature of repairs.[39] This practice is not always correct. Many alterations are in the nature of improvements, and improvements are capital expenditures. This is the position taken by the Treasury as is shown by the following quotation:

REGULATIONS. No deduction from gross income may be made for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property, or for any amounts expended in restoring property or in making good the exhaustion thereof for which an allowance for depreciation or depletion or other allowance is or has been made, ... (Art. 581.)

. . . . (3) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion, or obsolescence any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses. (Art. 24.)

The author reiterates his advice that liberal allowances should be made for repairs and depreciation, and that no expenditures should be charged to capital if there is any doubt about the items. Sometimes so-called alterations may properly be charged off as a necessary expense of the business. If so, some name other than alterations should be found for the expense.

RULING. Expenditures by a taxpayer in altering a building to conform to a street widening, which alteration does not increase the value of the building, constitute a business expense for the year in which such expenditures are incurred, deductible only in the return of net income for that year, and any division of such deduction so as to spread the same over the returns for a period of years, whether called

[39] *Connecticut Mutual Life Insurance Co. v. Eaton*, 218 Fed. 206; see page 1007.

a depreciation charge or otherwise, is unauthorized. (Bulletin "F," page 8.)

If the expenditures in such cases are substantial or exceed the income or if the alterations prevent the building from being used for a considerable period, it is possible that the cost should be capitalized. Any damages collected would be an offset against the cost.

Apartment houses.—See "Buildings," page 1030.

Automobiles.—Under ordinary conditions the rate of depreciation on automobiles should be fixed at not less than 20 per cent per annum. This rate has been adopted by the tax commission of one of the states. The *Primer* states that "the estimated lifetime . . . . of automobiles used for business or farm purposes and farm tractors" is "four to five years."[40] A rate of depreciation based on an estimated life of three years may not be excessive if adequate allowance is made for residual value. In the oil industry the Treasury allows 33⅓ per cent.[41]

While five years may appear to be a high estimate for the life of the average automobile it must be remembered that the nature of the asset permits repairs to be made on so extensive a scale as to reduce materially the necessity of complete replacement. Tires are frequently renewed, motors are replaced and in some cases (e.g., the taxicab companies) bodies are entirely rebuilt. Depreciation, therefore, as distinct from repairs and renewals, may be a smaller factor than appears at first glance. Of course, full allowance must be made for "accrued" wear and tear.

In some cases estimates of depreciation are based on mileage:

The second illustration, supplied by a manufacturer of metal products, indicates that an estimate of depreciation based on expected

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[40] *Income Tax Primer*, 1918, question 99.
[41] *Manual for the Oil and Gas Industry* (revised August, 1921), page 64.

performance can become very exact. This company calculates its depreciation on Ford cars used by its salesmen at 2 cents a mile and reports that the last thirty cars sold, exchanged or scrapped showed an average depreciation of 1.9 cents per mile and that these thirty cars were operated between five and six hundred thousand miles.[42]

REGULATION. . . . . No such allowance may be made in respect of automobiles or other vehicles used chiefly for pleasure, ... (Art. 162.)

Books—business and professional.—The Treasury formerly ruled that the cost of professional books was not a business expense but was an investment of capital against which depreciation may be charged.[43]

Roughly speaking, books in a technical library depreciate at a rate sufficiently rapid to justify charging off the total year's purchases in the case of libraries which are being kept up to date. This obviates the necessity of an annual revaluation of the library and is now permitted by article 104.

Buildings.—Obviously no general rate applies to buildings, since methods of construction, materials used, purposes, etc., affect the wear and tear incident to use. In a case relating to depreciation of apartment houses, the government allowed 3 per cent (see below). Perhaps this was a fair rate under laws which excluded the factors of inadequacy, change in character of neighborhood and other items of obsolescence. Under the 1921 law[44] obsolescence must be taken into consideration. Three per cent is the rate frequently used by manufacturers for slow-burning brick structures; and 2 per cent is the minimum rate for concrete, brick and steel fireproof structures. Perhaps 2½ per cent is more nearly correct.

[42] *Depreciation—Its Treatment in Production,* Chamber of Commerce of U. S., October 15, 1921.

[43] Bulletin "F," page 11.

[44] Obsolescence was first allowed under the 1918 law; see page 1077.

Where walls are subjected to unusual strain or vibration, a rate of not less than 4 per cent should be used.

In a state in which the subject has been carefully studied, a rate of 2 to 2½ per cent for cement or brick buildings and 3 to 5 per cent for wooden buildings has been adopted.

The National Machine Tool Builders' Association uses these rates: brick buildings, 3 per cent; frame buildings, 5 per cent.

The Treasury states:

> Ruling. A frame building may remain serviceable for a period of 20 to 30 years, while a building of steel, concrete, and stone construction may have a life of 50 to 100 years. (Bulletin "F," page 7.)

In the case of an apartment house the jury found that 3 per cent was a proper rate of depreciation.[45] This was the rate allowed by the government, while the plaintiff claimed 5 per cent. The apartment house is situated at No. 320 West 84th Street, New York, a very desirable location.

The Treasury takes the following general position on the question of depreciation, which applies particularly to the case of buildings:

> Regulation. . . . . No modification of the method should be made on account of changes in the market value of the property from time to time, such as, on the one hand, loss in rental value of the buildings due to deterioration of the neighborhood, or, on the other, appreciation due to increased demand. The conditions affecting such market values should be taken into consideration only so far as they affect the estimated useful life of the property. (Art. 166.)

The foregoing regulation refers exclusively to depreciation. When change in the character of a neighborhood or other causes result in an ascertainable loss the claim for depreciation (which now includes ordinary obsolescence) should be correspondingly increased.[46]

The following quotation from a recognized authority on

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[45] *Cohen v. Lowe*, 234 Fed. 474 (1916).

[46] For full discussion of obsolescence of buildings, see page 1086.

real estate and buildings emphasizes the need for special study of each particular case.[47]

When we ask what is the probable length of life of a modern building it is like asking an insurance examiner what is the probable life of a man. The insurance examiner replies "tell me the history of the man, of his father and mother, of his habits, of his occupation his physical condition, and I will tell you, barring accidents, what his probable life will be." In considering the probable life of a steel structure or of an ordinary building, the problem must be approached in the same way. Who built the building? Who maintains it? How were its foundations laid? What is its use? To attempt to sum up the problem of depreciation for any building requires that we take into consideration, first, the design of the building and of its foundations; second, the type as adapted to its locality and purpose; third, its construction and material; fourth, its operation and maintenance.

Anyone who attempts to pass judgment without this information is merely guessing in the dark. As an illustration of what I mean, take the case of a hotel, 10 stories, 50 x 100, built in the very finest way at a cost of $225,000 by an experienced investor and apparently good for a life of 40 years. It is located at 157 W. 124th St.

This splendid building depreciated so fast that it had to be destroyed as a hotel in seven years. Why? Because it was misplaced and was a failure. It cost $50,000 to convert it into a storage warehouse and it became a perfect building and good for perhaps 50 years for this purpose, provided it is reasonably maintained. But suppose it is neglected and abused, its automobile elevator allowed to wear out and no repairs made to keep it up to a reasonable standard of usefulness, how much can its natural life be shortened? The building, — West — Street, was worth $48,000 one year ago. The tenant spent $9,000 on it and it is worth $72,000 today or 50% appreciation.

Who is to judge of these conditions and what is his judgment worth and who will accept it? If we say that the life of a hotel is 30 years; of an office building 40 years; of a loft building 50 years; of an apartment house 25 years, of a non-fireproof structure, or a mill construction 35 years, who is to successfully contradict us and on what conditions of use or abuse, of care or neglect, of bad management or wise management, is all this to be decided? In my opinion, the plan of estimating 2½% on the mortgage is another way of guessing on broad general lines because in every case land value is part of the mortgage and leaves haphazard the proportion the building represents.

Look at the beautiful Blair Building at 24 Broad Street and

[47] "Depreciation of Buildings," by Frank Lord, vice-president, Cross & Brown Co., New York City.

ask me how much this superb building in a superb locality with a generous upkeep will depreciate and I will reply that a structure under such ideal conditions may last for 60 years not only because its design and construction are ideal, but its owners are ideal. The same may be said of the new Stock Exchange and the Bankers Trust Building opposite, but when you have named 20 or 25 buildings downtown and a dozen uptown, headed by the U. S. Rubber Building, you have exhausted the list of preferred risks and there are all sorts of grades and conditions to be classified. I do not say that they can not be properly classified and a reliable grading arrived at, for purposes of estimating probable depreciation, but as a practical question, the labor and cost is too great and in the end it comes back to definite considerations to be weighed for each building as to its birth, life and history coupled with engineering knowledge and judgment, and summed up by real estate experience and honest appraisal.

In the absence of this kind of knowledge and appraisal, we must be content to accept the method generally adopted of taking 3% for brick and stone and 4% for frame buildings as a fair measure of depreciation, and where the danger signals are flying adapt our own judgment to each particular problem.

The most pronounced cause of loss in real estate has been the failure of owners to set aside each year 3 to 5% of their income to make extraordinary repairs and to replace worn out buildings. When they find their income reduced to the vanishing point, they consult their lawyers who in turn consult some chance real estate broker who advises a sale for land value. The property is sold to some wise speculator who remodels it at a third of its original cost and rents it to such advantage that it pays better than ever before, proving that the depreciation that wiped out the former owner's equity was the depreciation of bad management and neglect.

For fully 20 years I have been advising investors to put 5% of their net income into a sinking fund to meet this problem, and one investor who had adopted this practice told me that one property had paid for itself out of surplus earnings above 7% on his invested capital. . . . . Another unknown factor in large buildings is whether they are wind braced or not.

There are many such factors in the constitution of a building buried securely from sight which go to the heart of the matter, and a life insurance examiner might as well try to pass an applicant by looking at him and talking politics with him as for one of us to decide conclusively what should be the depreciation of various types of structures from such general knowledge as may be obtained without careful investigation of a good builder and a capable engineer, coupled with experienced real estate judgment of the probable fitness of the building for the future and who its owner and manager is to be.

Buildings under construction.—When buildings, particularly factories, are partly completed the question arises as to the date from which to compute depreciation. In most cases the construction account is not closed until the building is entirely completed, even though a considerable portion of it may have been in use for some time. It has been suggested that the depreciation should be based upon an average date, except in cases in which depreciation could not be said to commence until actual completion.

The same reasoning would apply to items other than buildings, such as storage tanks, etc., which are carried in construction account until a group of units is completed. Accounting practice, however, requires that all costs of construction be capitalized until operations commence; therefore the allowance for depreciation on an uncompleted plant, no part of which is in use, would simply be debited and credited to the same account.

Ruling. The term "useful life" as used in article 161, Regulations 45, is interpreted to mean the period of time over which an asset may be used for the purpose for which it was acquired. In the case of a new building, this period starts at the time the building is completed and capable of being used. Buildings under construction are not subject to a depreciation allowance for income tax purposes. (C. B. 4, page 178; O. D. 845.)

The foregoing ruling is broad enough to include cases in which a building may be partly occupied before being entirely completed. In such cases partial depreciation should be computed from the date of such partial occupancy.

Vacant houses held for sale.—

Ruling. A taxpayer engaged in the business of repairing and building houses, which he holds for sale, is entitled to a deduction for depreciation in respect of them even though they are kept vacant before sale.

Amounts expended for repairs on the houses during the period between the completion and sale are allowable as a deduction as a business expense, provided they neither add to the value of the property nor prolong its useful life. (C. B. I-1, page 169; I. T. 1342.)

Canning industry.—The machinery and equipment used in the canning industry call for rates of depreciation, from 10 to 15 per cent, and in some cases even as high as 20 per cent. This is due to the seasonal character of the industry, the lack of skilled labor and the natural acids which corrode the machinery and equipment very rapidly.

Cash registers.—The average life of a good cash register is from ten to twenty years, although some are in use to-day which were sold more than twenty years ago. The reduction in value during the early years is heavy, as with typewriters, and machines are frequently exchanged. This is due to inadequacy more than to depreciation. If an annual rate is to be constant over the expected effective life of the machines, it would be unwise to fix it at less than 15 per cent.

Chemical industry.—In the chemical industry buildings depreciate about 2½ to 3 per cent. The machinery and equipment depreciation depends largely upon the nature of the product manufactured, the average being about 15 per cent.

Containers.—In certain kinds of business, such as breweries, milk depots, spring-water distribution, bakeries, etc., considerable numbers of containers, such as casks, kegs, bottles, cases, cracker tins, etc., are owned, which are used principally for convenience of transportation and are supposed to be returned when empty. As to these, no specific rate of depreciation can be fixed. Each case must be considered on its merits. Rates given in the table on page 1068 are suggestive of good practice.

At balancing time an accurate inventory should be taken, if possible, but if not practicable, it will be necessary to make a calculation as to the number required for the normal operation of the business. An inspection of the reserve supply will serve as a check on the book valuation. In many cases concerns go on the assumption that all such containers are in

possession of someone who will in due course return them, but experience proves that considerable numbers are lost, broken or stolen, and that to carry these as stock on hand is inaccurate.

Contracts.—The Treasury now recognizes the position which the author has held for several years, viz., that any kind of property, tangible or intangible, may be amortized, depreciated or depleted either on the basis of market value at March 1, 1913, or upon cost since that time. The regulations are quite as liberal as could be desired.[48]

If an automobile dealer secures a valuable contract from a manufacturer, and turns it over to a corporation, the latter may claim as a deduction the cost of the contract spread over its life; but in this case as in all other similar cases the corporation cannot claim the deduction unless the payment for the contract was made in good faith and for proper consideration, and where there was any community of interest between the dealer and the company, the former would be compelled to return as taxable income the purchase price of the contract which the corporation claims to have paid to him.

Ruling. . . . . It is clear from the facts above set out that the P Company received under the contract between the M Company and A, a valuable and enforceable right. (*Seaver v. Ransom*, N. Y., 120 N. S., 639.) While not a direct party to the contract, the contract provides that it is made for the benefit of the company and the company is given the right to select the advertising matter to be issued. Although the contract was never assigned to the company, the latter possessed under it the indefeasible right to a definite amount of advertising space for a period of years, a right enforceable in its name. This right was a gift from A, a majority stockholder, to the P Company and does not depend upon the execution of an assignment by the former to the latter; it exists by virtue of the contract itself.

It is therefore held that, under the contract between the M Company and A, the P Company was the owner of the right to receive certain advertising space for a period of years and that the company will be permitted to depreciate this right in computing its taxable net income. (C. B. I-1, page 168; I. T. 1222.)

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[48] Art. 163; see page 1039.

Copyrights.—Copyrights may be charged off under the same procedure as patents, except that the term is 28 years, which term, under certain circumstances, may be renewed for another 28 years. As most copyrights diminish rapidly in value, depreciation should not be based on their life. Revaluation of each one is the only satisfactory solution. A list of copyrights owned should be compiled. Inquiry based on this list will develop evidence as to the actual worth of the asset. The Treasury is attempting to base the depreciation on cost or March 1, 1913, value, spread over the term of the copyright or the life thereof remaining after date of acquirement or March 1, 1913.[49]

RULING. . . . . The annual allowance for depreciation of the copyright should be computed by an apportionment of the cost of the copyright over its life since its grant, and such cost must be limited to the author's actual capital outlay in securing the copyright, including the actual cost to the author of producing the book covered by the copyright, but not including any amount representing the value of the author's own time and labor. (C. B. 5, page 155; O. D. 966.)

Costumes—theatrical.—

REGULATION. . . . . properties and costumes used exclusively in a business, such as a theatrical business, may be the subject of a depreciation allowance.[50] (Art. 162.)

If adapted for "occasional" personal use, claim for depreciation is still allowable, but consideration must be given to the value of the personal use, in regard to which depreciation is not deductible.

Electrotypes, woodcuts, etc.—The arguments urged in case of patterns (see page 1057) apply with equal force to electrotypes, woodcuts, etc. Conservative publishers charge off almost the entire cost of plates as a direct cost of a first edition and are careful to revalue the balance of the account frequently. If a book or other publication is successful, the cost of plates,

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[49] Art. 167.
[50] See page 813.

etc., can be readily absorbed in its cost; but if it is not successful, no new orders can be expected, and it would be folly to carry the plates on the balance sheet at *any* valuation except as scrap metal. A number of bankruptcies have occurred in the publishing business through disregard of this principle.

Formulas.—

RULING. Formulas are not a character of property subject to annual depreciation deductions in a taxpayer's return; however, if after acquisition, a formula is found to be worthless, its cost may be charged off in toto in the taxpayer's return for the year in which its worthlessness was discovered. (C. B. 3, page 169; A. R. R. 339.)

Foundries.—Depreciation does not average more than 4 per cent on foundry buildings. Depreciation on foundry equipment, with the exception of flasks, patterns, and core boxes, should average not more than about 5 per cent; while on the articles mentioned the rate should range from 7½ to 33⅓ per cent. A high rate is necessitated by the fact that many patterns become obsolete because they are made in an experimental way.

Furniture and fixtures.—Furniture and fixtures have little residual value, and conservative concerns charge off by far the larger proportion of the cost. In most establishments many items, such as partitions, special shelving, etc., are charged to the fixture account. When frequent alterations and changes are made, most of such expenditure is in the nature of repairs or current expense and should be charged off at the time. If charged to an asset account, it should be distributed ratably over a few years' operations.

If it is important to write off actual depreciation only, it will be found that 15 per cent per annum represents a fair average allowance. The tax commissioner of one of the states has adopted a standard rate of 10 per cent, but in exceptional cases allows as much as 25 per cent.

Usually in a going business assets are not treated on the

basis of realization values, but in the case of furniture and fixtures so many changes are made to suit the convenience and whims of executives and clerks, and offices are moved so often from one place to another, that these assets have a most uncertain value.

Leaving out of consideration the complex question as to what are and what are not landlord's fixtures, it may be laid down as a general rule that the minimum rate of depreciation upon machinery and fittings erected upon leasehold property should be sufficient to wipe off the book value before the expiration of the lease. In the case of machinery, etc., which will not become landlord's fixtures, a lesser rate may be permitted, but it is imperative that in such a case it be clearly understood and agreed what are to be the landlord's fixtures and what are not.

Goodwill.—No claim for depreciation, as such, of goodwill, trade-marks or trade-brands should or will be allowed, but when goodwill was purchased or had a value March 1, 1913, and later declines in value on account of such causes as state or national prohibition, depreciation in the nature of obsolescence will be allowed.[51]

REGULATION. Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses, and franchises.[52] Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner. (Art. 163.)

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[51] See page 1088.

[52] [Former Procedure] In the preliminary edition of Regulations 45 among the examples of intangibles subject to depreciation was "limited leases." The item was omitted in the April 17, 1919, edition and in the amendment of October 7, 1919.

The regulation fails to state that the value of the property at March 1, 1913, is subject to depreciation even though the asset was not acquired by capital outlay.

Hat factories.—The depreciation on hat factory buildings is about 2½ per cent; on equipment from 4½ to 10 per cent; while on the molds used in the business it is the same as on the patterns in a foundry.[53]

Horses.—Horses become less valuable not only through age but also through hard usage. If depreciation is calculated on an annual percentage basis, the allowance should usually be from 10 to 25 per cent of the cost. The alternative method of basing depreciation on periodical revaluations is favored by many because it makes possible a closer approximation of actual deterioration. Certainly, in the case of horses, valuations can be established more accurately than in the case of most assets. Fairly frequent revaluations are therefore desirable.

Intangible property.—Intangible property is held to be subject to depreciation and obsolescence. (See discussion under "Leaseholds," page 1041, and "Goodwill," page 1039.)

Land.—The regulations deal with depreciation in the value of land as follows:

> Regulation. . . . . The allowance . . . . does not apply . . . . to land apart from the improvements or physical development added to it.[54] . . . . (Art. 162.)

Generally speaking, land does not depreciate. Declines in values are not allowable deductions until sales are made, at which time the resulting losses may be deducted as losses, and not as depreciation. But if it can be shown that depreciation, as the term is used in the law, actually occurs in land, credit

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[53] See pages 1038 and 1057.
[54] See Chapter XXXVIII.

may be claimed, even though the foregoing regulation would seem to indicate otherwise.

The law[55] permits "a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business."

It would therefore seem that if land which is used in the business of farming depreciates in value because of its employment, and not because of fluctuations from other causes, credit may be claimed therefor.

Declines in values due to erosion may more properly be dealt with as losses, but the law seems to have specifically provided for depreciation due to exhaustion.

If a farmer were to produce successive crops from his land without being able to restore the land to its former fertility, it would be inequitable to compel him to return for taxation the value of the crops produced and prohibit the taking of credit for one of the chief items of cost of production—and depreciation in the value of land due to exhaustion can hardly be called anything but an operating cost.

The question of soil exhaustion is aptly summarized in the following quotation:[56]

> The measure of capital loss sustained by the farm owner is the amount of the elements of plant life removed from the soil and not actually replaced. This capital loss can be determined in dollars and cents. The dollars and cents so determined are not subject to taxation. They have been taxed in the case of nine farm owners out of ten having a taxable income. Steps should be taken, where possible, to get a return of taxes illegally assessed in the past, and to insure consideration of the item of soil exhaustion in returning income subject to taxation in the future.

Leaseholds.—No mention of leaseholds is made in the 1916, 1917, 1918 or 1921 income tax laws. Because of the importance of this class of assets the Treasury has issued comprehensive regulations dealing with its treatment. Many kinds of property are operated under leases which may be held or

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[55] Section 214 (a-8).

[56] *Soil Exhaustion in Relation to the Income Tax Laws,* by Powell Chandler, *Administration,* October, 1922, pages 461-465.

sold to others. A leasehold becomes the personal property of the lessee or purchaser. Its value or cost is an integral part of his investment.

REGULATION. Where a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. . . . . (Art. 109.)

By reason of the temporary character of a leasehold its cost may be amortized during the term of its life from the date of purchase so that an equal portion of its cost shall be charged against the operations of each year.

A leasehold is property. Section 325 (a) of the 1921 law specifies leaseholds as tangible property for the purpose of the excess profits tax. Neither can it be denied that a leasehold loses its value by the mere effluxion of time. Consequently it is not only proper but necessary that its amortization be recorded on the books of its owner.

In a ruling of the Committee of Appeals and Review the nature of a lease is well described:

RULING. . . . . The facts appear to be that this company was organized with a small amount of capital stock, none of which was paid up, and later it secured a lease to wharf property, no bonus being paid for the lease. The business of the company is the subletting of this leased property.

It is clear that the income of the company is derived chiefly from the possession of a capital asset which is not capital in name only, but a real tangible asset, to wit, its lease upon the wharf property. . . . . (C. B. 3, page 341; A. R. R. 315.)

DEPRECIATION ALLOWED LESSEE.—

RULING. Ordinarily an allowance for depreciation may be taken only on account of property owned by the taxpayer and used in trade or business and may not be taken on account of property of which he is merely the lessee. This will not preclude the deduction each year by the lessee of an aliquot part of the cost or the bonus paid for the lease. In the case of additions, improvements, or betterments to the property made at the expense of the lessee, which, according to the terms of the lease, revert to the lessor at the termination of the lease, the lessee may apportion the cost of such additions, etc., over the life of the lease and deduct an aliquot part thereof

each year. If, however, the life of improvements for business purposes made at the expense of a lessee is less than the life of the lease, depreciation may be taken by the lessee instead of treating the cost as additional rent.[57] Stockholders of a corporation are not entitled to deduct in their individual returns any amount on account of depreciation of the property of the corporation from which they receive dividends. (Bulletin "F," page 32.)

The foregoing covers only the period subsequent to March 1, 1913. When a lease executed prior thereto had an ascertainable value on that date such value is capital and may be returned to the lessee free from tax.[58]

Its value at March 1, 1913, should be ascertained and set up on the books, and depreciation claimed on such value, pending a final court decision thereon. Under present procedure the Treasury does not recognize appreciation in leaseholds at March 1, 1913.

Ruling. A lessee is not entitled under the Revenue Acts of 1916, 1917, 1918 or 1921, to an allowance for depreciation based on the value of his lease as of March 1, 1913, if acquired prior thereto, but where a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. (T. D. 3414, dated November 25, 1922.)

When lessee must return property unimpaired.—

Ruling. The M Company leased to the O Company certain street railway properties.

By the terms of the lease the lessee is required to return the leased properties to the lessor at the end of the lease in the same condition they were in at the date of the lease.

All of the stock of the lessor company is owned by the lessee company. Inquiry is made whether for Federal income tax purposes, the lessee company may charge depreciation of the leased properties on its books.

Held, that inasmuch as the properties leased must be returned to the lessor company at the end of the term of the lease in the same order and condition as they were in at date of lease, there will be no depreciation of such properties while in the lessee's possession

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[57] For obsolescence of improvements on leased land, see Chapter XXXVII.

[58] C. B. 3, page 145; O. D. 720. See also Chapter XXXVIII regarding leaseholds.

and therefore no deductions by the lessee for depreciation will be allowed. Amounts expended to keep the properties in good condition and repair are deductible as business expenses in the returns of lessee corporation for the years in which such amounts are expended. (C. B. 5, page 151; O. D. 1014.)

The foregoing ruling is not sound. Assume that before the end of the lease a large part of the equipment is scrapped in a single year because it has worn out. The lessee would have to replace it. The Treasury would not permit the replacement to be charged to income as "repairs." Although depreciation actually accrues year by year, the Treasury under the ruling would deny the deduction, and neither the lessee nor lessor would get the benefit clearly provided by the law. This reasoning is based on the fallacious theory that repairs and maintenance offset depreciation.[59]

Machinery and equipment.—While specifically declaring that "each taxpayer must determine the probable lifetime of his property without regard to the . . . . figures given," the *Primer* makes the statement that "the estimated lifetime of ordinary machinery is ten years."[60]

So many factors affect the length of the life of machinery that the only satisfactory solution is to assign to each machine its own individual rate of depreciation. What that rate shall be must be determined by experience with similar machines in similar circumstances. These circumstances vary widely. Two machines exactly alike in the beginning may show a considerable difference in length of life and service when installed in different plants. An uneven or unstable foundation may shorten the life of one machine. Cleanliness and lubrication, care and skill in operation and continuity of service are important factors. Climatic conditions often enter to complicate the problem, machinery in some sections of the country deteriorating more rapidly from this cause than in other sections. Again the policy relative to repairs and maintenance

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[59] See page 1006.

[60] *Income Tax Primer,* 1918, question 99.

affects aggregate renewal costs. A high standard of upkeep means lower depreciation rates. Often a considerable part of the ordinary wear and tear for which depreciation reserves are created is charged to operating expenses in the form of repairs and maintenance. Small parts of machines are constantly wearing out or breaking and are being renewed as an expense. Sometimes nearly every part of a machine is renewable and in such a case it is quite conceivable that at the end of five or six years the machine may be so largely renewed as to be about as good as new. Where a condition of this sort exists the depreciation rate should be lowered.

It is apparent that no hard-and-fast rule can be laid down. The nearest possible approach to a general rule is to state that in addition to charging all repairs and part renewals to operating expense, from 7½ to 12½ per cent should be written off annually from the original cost to provide for normal depreciation. When double shifts are made necessary the rate is increased. In certain cases engineers have estimated that the increase in rates due to overtime and "diluted labor" is from 50 to 100 per cent.

In the case of a heavy machine tool the life is usually considered to be from fifteen to twenty years, ignoring the question of obsolescence; yet the rate of the National Machine Tool Builders—which is 10 per cent and is for favorable conditions and applies to the total original value and not to a decreasing value—should be given weight.

It is invariably desirable that a subsidiary ledger be kept containing details not included in the machinery accounts of the general ledger. Such detailed records not only assist in the determination of proper rates of depreciation but they are also of great value in determining the amount to be written off in case of a sale or fire.[61]

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[61] In a well-known English compilation the depreciation rates of "American-made" machinery are from ¾ of 1 per cent to 2 per cent higher than on the same class of machinery manufactured in England. No explanation is given. This is of interest when quotations from English reports or decisions are used as precedents.

Mine equipment.—A company mining bituminous coal claimed depreciation on the following basis:

Mine equipment	6 2/3%
Power houses and machinery	6 2/3
Tipples, inclines and screens	6 2/3
Saw mill	6 2/3
Tenement houses	5
Buildings and other houses	5

The inspector refused to allow the deduction because the depreciation was not entered on the books, but on appeal to Washington the rates were passed as reasonable. In this case, the quantity of coal in the ground was sufficient to warrant writing off depreciation on an estimated life of twenty years. The quantity of unmined coal must always be taken into consideration.

When it is feasible to apply different rates to a mining plant, the units of which are classified in much detail, higher rates than the above need to be applied to such equipment as mining machines and mine cars. Rates of 12½ to 20 per cent for mining machines, and 25 per cent for mine cars, have been suggested.

Regulations. (*a*) All expenditures for development, rent, and royalty in excess of net receipts from minerals sold shall be charged to capital account recoverable through depletion, while the mine is in the development stage. Expenditures made in order to maintain the mine at its normal output shall be deducted as an expense in the year in which the expenditure is made or accrues. Any expenditure for extraordinary development and equipment, such as stripping, shaft sinking, tunneling, and other work beyond that necessary to maintain the mine at its normal production or output should be carried forward and apportioned and deducted as an operating expense in the years to which it is applicable.

(*b*) All expenditures for plant and equipment shall be charged to capital account recoverable through depreciation, while the mine is in the development stage. Thereafter the cost of major items of plant and equipment shall be capitalized, but the cost of minor items of equipment and plant, necessary to maintain the normal output, and the cost of replacement may be charged to current expense of operation. . . . . (Art. 222.)

(*a*) The Act provides that deductions for depreciation of im-

provements "according to the peculiar conditions in each case" may be taken by a taxpayer owning or leasing mining property. This is deemed to include exhaustion and wear and tear of the property used in mining of deposits, including a reasonable allowance for obsolescence . . . .

(*b*) It shall be optional with the taxpayer, subject to the approval of the Commissioner, (1) whether the value of the mining property plus allowable capital additions but minus estimated salvage value shall be recovered at a rate established by current exhaustion of mineral, or (2) whether the value of the mineral deposit on the basic date plus allowable capital additions shall be recovered through depletion and the cost of plant and equipment less the estimated salvage value shall be recovered by reasonable charges for depreciation . . . . at the rate determined by its physical life or its economic life or, according to the peculiar conditions of the case, by a method satisfactory to the Commissioner.

Estimated physical life.—

(*c*) The estimated physical life of a plant or unit thereof (including buildings, machinery, apparatus, roads, railroads, and other equipment and improvements whose principal use is in connection with the mining or treatment or other necessary handling of mineral products) may be defined as the estimated time such plant, or unit, when given proper care and repair, can be continued in use despite physical deterioration, decay, wear and tear.

Estimated economic life.—

(*d*) The estimated economic life of a plant or unit thereof is the estimated time during which the plant or unit may be utilized effectively and economically for its intended purposes and may be limited by the life of the property or of that portion of the mineral deposits which it serves but can never exceed the physical life.

Adjustment of depreciation reserves.—

(*e*) Any difference between the salvage value of plant and equipment and the depreciated value remaining at the termination of mining operations shall be returned as profit or loss in the year in which it is realized.

Salvage value of equipment.—

(*f*) Nothing in these regulations shall be interpreted as meaning that the value of a mining plant and equipment may be reduced by depreciation deductions to a sum below the value of the salvage when the property shall have become obsolete or shall have been abandoned for the purpose of mining. In estimating the salvage

value of the equipment at the end of its estimated economic life due consideration may be given to its specialized character and the cost of dismounting and dismantling and transporting it to market.

LAND MAY NOT BE DEPRECIATED.—

(*g*) Nothing in these regulations shall be interpreted to permit expenditures charged to expense in any taxable year or any part of the value of land for purposes other than mining to be recovered through depletion or depreciation. (Art. 224.)

EXTENSION OF ECONOMIC LIFE OF EQUIPMENT.—If depreciation has been charged annually on the basis of the exhaustion of the mineral, and additional ore reserves are developed for which a discovery value may not be claimed,[62] it is permissible to base subsequent depreciation charges on the estimated remaining physical life of the mine equipment so as to spread the deductions over a longer period.

EXPENDITURES WHICH BENEFIT THE FUTURE.—It is claimed by many competent mining engineers that good practice in the mining industry permits the charging to maintenance of expenditures for improvements the benefits and advantages of which extend over a period of years. Under ordinary accounting practice all expenditures which benefit the future should be set up as deferred assets and allocated to the succeeding periods which realize the benefits.

The recent federal tax laws recognize that general principles may be modified in a given trade or business. When the modifications are accepted as controlling and as being good practice by a majority of concerns in such industry, general principles are superseded. The custom of charging improvements to maintenance does not extend to original development and equipment, but is limited to expenditures which are made after mines are in operation. The theory is that after operations have begun practically all so-called improvements "are really nothing but expenses required to keep the property from depreciating."[63]

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[62] See page 1131 *et seq.*
[63] J. R. Finlay, *The Cost of Mining,* page 65.

Development costs.—Under article 223, a taxpayer is given the option of charging to expense or capitalizing exploration expenditures, "drilling of wells, building of pipe lines, and development . . . ." The election once made is held to be binding in subsequent years.

Ruling. A corporation which in 1916 and 1917 exercised its option and charged to capital account such expenditures as wages, fuel, repairs, hauling, etc., in connection with the exploration of property, drilling of wells, etc., may not subsequently amend its returns covering such period so as to transfer such items to operating expenses to accord with their treatment in its 1918 return. (C. B. 4, page 199; Digest O. D. 796.)

In permitting items which are ordinarily regarded as capital to be charged to expense, the Treasury recognizes the hazardous character of the oil industry.

Depreciation of equipment of oil and gas wells.—

Regulation. Both owners and lessees[64] operating oil and/or gas properties will, in addition to and apart from the deduction allowable for depletion as hereinbefore provided, be permitted to deduct a reasonable allowance for depreciation of physical property, such as machinery, tools, equipment, pipes, etc., so far as not in conflict with the option exercised by the taxpayer under article 223. The amount deductible on this account shall be such an amount based upon its cost (or fair market value as of March 1, 1913, if acquired prior to that date), equitably distributed over its useful life as will bring such property to its true salvage value when no longer useful for the purpose for which such property was acquired. Accordingly, where it can be shown to the satisfaction of the Commissioner that the reasonable expectation of the economic life of the oil or gas deposit with which the property is connected is shorter than the normal useful life of the physical property, the amount annually deductible for depreciation may for such property be based upon the length of life of the deposit. . . . . (Art. 225.)

Detailed classifications of both oil and gas well equipment and the rates of depreciation applicable thereto have been published by the Treasury.[65] So far as is known this is the

[64] T. D. 3386, issued August 22, 1922, amended article 170, Regulations 33 (revised), so as to grant lessees specific deduction for depreciation.

[65] *Manual for the Oil and Gas Industry*, 1921, page 63.

only industry for which the government has officially suggested classifications and rates.

The Treasury suggests that well equipment be depreciated at the same rate as that at which the oil or gas reserves are depleted. The reason for this method in preference to a straight line rate of depreciation such as 10 per cent a year, is that after a well has produced for a few years there is practically no salvage value to the casing and tubing. Casing and tubing are the large and small sizes of pipe which are put into a well to protect the oil or gas from physical encroachments in its passage from the producing sand to the mouth of the well.

If a well has produced for five years, under ordinary circumstances the casing and tubing would be useful for several years more if left in the well and the well continued to produce. If the well ceases to produce and the casing and tubing are pulled out, they may not be in such a condition as to warrant the expense of transporting them any distance, especially over a rough country, and putting them into another well for the remainder of their life. Furthermore, the operations of pulling out casing and putting it down into a well are hazardous both as to the expense which may be involved and the risk of injuring the material. The recommendation of the Treasury to depreciate the well equipment at the same rate as the mineral contents are depleted is reasonable.

There may be circumstances under which this method of depreciation will not apply. Some producers pull the outer casing as soon as a well begins to produce, and use it in pipe lines or other wells. When the newly drilled well turns out to be a dry hole, that is, it produces no oil or gas, probably all the casing and tubing will be pulled out. Equipment rapidly deteriorates under these conditions. In these instances the rate recommended by the Treasury will not apply, and the equipment must be depreciated at a high rate for the period during which it has been in the well.

Rigs and cleaning-out equipment.—A rig used at only one well during a year does not sustain as large a loss of value as the rig which is used at two or three wells. A larger loss occurs when a rig is taken down, moved, and put up again than when the rig is in constant or partial use at one well. An estimate should be made of the number of wells at which steel rigs and cleaning-out equipment can be used, and a rate of depreciation to be applied to the equipment for its use at each well may be calculated from such an estimate.

Gasoline absorption plants, carbon black factories, and refineries.—Gasoline absorption plants, carbon black factories, and refineries are frequently located in the gas and oil fields. The rate of depreciation depends in large part upon the life of the field.

Gasoline may be obtained in larger quantities from gas which is produced in a low pressure field, that is, a field which has been producing gas for some time. The initial flow of gas from a new field is at a high pressure. The gas which is first produced under such circumstances does not contain as great a percentage of gasoline as the gas which comes later when the production has become settled. Low-pressure gas will not flow freely through a pipe line for any great distance without some artificial aid, so that it behooves the gasoline manufacturer to locate his plant as near as possible to the wells in order to avoid the burden of large carrying costs in the price of the gas he uses. At the present time it is unlikely that the productive life of a low-pressure field will be equal to the physical life of the gasoline plant. Accordingly, the probable life of the field should be taken into account in calculating the depreciation rate of the plant.

The depreciation rate of a carbon black factory will depend upon the life of the field, but the carbon black manufacturer is also likely to have an obsolescence charge by reason of being forced to abandon his plant as a result of the adverse legislation arising from popular opinion that such a plant uses

great quantities of gas which should be made available for fuel and lighting purposes in homes.

There are three types of refineries, the refinery of poor construction located in and drawing its supply from one oil field, the refinery of fair construction which draws its supply from a number of fields, and the refinery of the best possible construction, located on the Atlantic or Gulf Coast, which gets its oil from all sections of the United States as well as from other countries. In the first case the life of the particular refinery is determined by the probable life of the field in which it is located. In the other two cases the rates would probably depend on the estimated life of the property itself rather than upon the life of any particular field.

Orchards.—See Chapter XLIV.

Organization expenses.—Such expenses may not be deducted by way of depreciation.[66] For comments on this point see page 843 *et seq.*

Patents.—A patent derives its value from the fact that it is a monopoly. The moment the monopoly ceases because of the termination of the patent term, the value is wiped out. It is true that in many cases the momentum gained during the period of legal monopoly may give a marketing advantage which is of some value for a considerable period after the expiration of the term of the patent, but this is an asset closely akin to goodwill and as such is not of a nature suited to serve as a basis for the establishment of depreciation reserves. In other words a proportionate part of cost or value March 1, 1913, of a patent should be charged off periodically so that the cost may be completely extinguished by the expiration date. Since patents in this country are issued for a term of 17 years, 17 should constitute the maximum number of annual instalments.

[66] Bulletin "F," page 12.

Life more than 17 years when application was pending March 1, 1913.—When an application for a patent was pending March 1, 1913, and the patent was issued and dated March 1, 1915, the value of the patent March 1, 1913, subject to depreciation should be spread ratably over 19 years. The capital value at March 1, 1913, is the amount to be returned through depreciation charges, and it is obvious that the property which existed at that date had a remaining life of 19 years and not 17 years.

The Treasury, however, holds in a recent ruling that a patent application has "no rights in the nature of property." The author believes that the ruling is unsound.[67]

Of course, it by no means follows that a patent possesses value during its whole life. Revaluations should be made frequently. They often reveal the desirability of readjusting depreciation rates and of charging off sums as losses.[68] It may be that the process covered by the patent has become obsolete or that the article made is not in demand or is salable at a price too low to justify its manufacture. Again, if a patent is purchased after part of its term has expired, the rate should be based upon the unexpired term only.

A patent which has been leased and not purchased should not be treated as an asset except to the extent of its actual cost in fees, etc., unless acquired before March 1, 1913. To capitalize a patent lease purchased since March 1, 1913, at any sum in excess of cost would be as incorrect as to capitalize goodwill in excess of cost, although one or the other is a latent asset in every paying concern.

Regulation. In computing a depreciation allowance in the case of a patent or copyright, the capital sum to be replaced is the cost (not already deducted as current expense) of the patent or copyright or its fair market value as of March 1, 1913, if acquired prior thereto. The allowance should be computed by an apportionment of the cost of the patent or copyright or of its fair market value as of March 1, 1913, over the life of the patent or copyright since its

[67] I-35-482; A. R. R. 1086; see page 657 *et seq.* for full discussion.

[68] See page 1055.

grant, or since its acquisition by the taxpayer, or since March 1, 1913, as the case may be. If the patent or copyright was acquired from the Government, its cost consists of the various Government fees, cost of drawings, experimental models, attorney's fees, etc., actually paid. If a corporation purchased a patent and paid for it in stock or securities, its cost is the fair market value of the stock or securities at the time of the purchase. . . . . (Art. 167.)

In many cases the market value of securities indicates the fair market value of the assets purchased with such securities, but in many other cases the value of the asset and the value of the securities issued therefor vary to a considerable extent. The chief reason for the variation is that the securities issued may be part of a larger issue or sales may be made under unusually favorable or unfavorable conditions.

Depreciation based on fair market value at March 1, 1913.—

Regulation. . . . . Depreciation of a patent can be taken on the basis of the fair market value as of March 1, 1913,[69] only when affirmative and satisfactory evidence of such value is offered. Such evidence should whenever practicable be submitted with the return. . . . . (Art. 167.)

"Satisfactory" evidence is a reasonable requirement and should be met. The taxpayer is entitled to produce evidence of subsequent development and success as bearing on the probable value at March 1, 1913. The estimates of inventors and others as to values, while not conclusive, are *prima facie* evidence when it appears that such estimates were made in good faith.

The value placed upon patents by competition is difficult to ascertain but is sometimes available. The testimony of those who have valued patents, bought and sold them or participated in negotiations, is admissible.[70]

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[69] [Former Procedure] Depreciation was formerly permitted only on the basis of actual cost thereof and not on estimated value as of March 1, 1913 (Reg. 33, 1918, Art. 174), but for some years the author has contended that the March 1, 1913, value was permitted by the law. (See *Income Tax Procedure*, 1919, pages 572-573.)

[70] For full discussion of value at March 1, 1913, see page 649.

ALLOCATION OF EN BLOC VALUE TO EACH PATENT.—Usually the March 1, 1913, value of two or more patents is determined as a whole. For depreciation purposes the Treasury in practice requires such en bloc value to be distributed equitably to the respective individual patents. The reason for this is that the most valuable patents may be those earliest issued and accordingly may require to be written off in large part prior to the high-tax years.[71]

RATE TO BE USED WHEN PATENT BECOMES OBSOLETE.—

REGULATION. . . . . If the patent becomes obsolete prior to its expiration such proportion of the amount on which its depreciation may be based as the number of years of its remaining life bears to the whole number of years intervening between the date when it was acquired and the date when it legally expires may be deducted, if permission so to do is specifically secured from the Commissioner. Owing to the difficulty of allocating to a particular year the obsolescence of a patent, such permission will be granted only if affirmative and satisfactory evidence that the obsolescence occurred in the year for which the return is made is submitted to the Commissioner. . . . . (Art. 167.)

WHEN PATENT RIGHT IS EXTENDED.—A corporation acquired patent rights for a period of 23.5 months. Subsequently a new right to extend for a period of eight years was secured. The taxpayer claimed the right to spread the depreciation over the remaining eight years, which the Treasury denied.[72]

PATENT LITIGATION DEDUCTIBLE AS EXPENSE.[73]—

RULING. . . . . The conclusion of the Committee is that the amounts expended by the corporation in the instant case in litigation, after the patent had been secured by B and had been transferred to the corporation, constitute necessary operating expenses and should not be capitalized. . . . . (C. B. 2, page 105; A. R. R. 98.)

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[71] For a discussion of the factors entering into the allocation see *Administration,* August, 1922, "Patent Valuations as Affected by Federal Taxation," by Ralph H. Allen.

[72] C. B. 5, page 156; A. R. R. 520.

[73] See Chapter XXXI.

When depreciation not taken in prior years.—

Regulation. . . . . The fact that depreciation has not been taken in prior years does not entitle the taxpayer to deduct in any taxable year a greater amount for depreciation than would otherwise be allowable. . . . . (Art. 167.)

Taxpayers cannot be estopped from revising accounting procedure when it is discovered that past procedure did not properly reflect net income.[74]

A patent may be purchased for $100,000. It may have ten years to run. During the first few years after purchase development work may be going on, there may be no gross income or net income, and it may be decided that no depreciation has taken place, consequently none is charged. After several years the commercial use of the patent begins and gross income is received. It may then be decided that depreciation should be charged. Surely it could not be held that any depreciation in the earlier years had taken place.

Ruling. . . . . In January, 1902, the M Company, then a newly organized corporation, acquired ownership of eight patents issuing therefor to A, the patentee, $900x$ dollars of stock of the corporation. This amount was subsequently increased $2x$ dollars by expenses of acquisition. The patents so acquired, except one, issued in 1900, had expired prior to January 1, 1917, but as of March 1, 1913, all but one were in effect. . . . . No depreciation was taken by the taxpayer on the patents which were capitalized, until the year 1917, when 1/17 of the book value was charged to expenses notwithstanding the fact that all except one of them had expired prior to January 1, 1917. . . . .

The basis for deduction authorized . . . . is the return of capital on an asset, the use of which in the trade or business is definitely limited in duration. The taxpayer did not elect, during the life of the patents acquired in 1902, to provide for this return of capital. Had he made this provision his surplus for invested capital purposes under the Revenue Act would have been correspondingly reduced.

He, therefore, can not now claim in a high taxable year, after

[74] **[Former Procedure]** The preliminary edition of article 167, Regulations 45, provided that "a taxpayer may elect not to take a depreciation allowance but such election if made is final and will control the returns for all subsequent years." It is a fair statement that nothing is final in income tax practice, even regulations, because the sentence quoted was omitted from the April 17, 1919, edition of the regulations.

the expiration of the life of the patents, an amount equivalent to one-seventeenth of the cost, thereby securing the benefit not only of a reduction in his taxable income for the year 1917, but the advantage of the investment, which in value is subject only to the definite limitations prescribed by the Act and the regulations. . . . . (C. B. 3, page 172; A. R. M. 95.)

It was possible, however, for the corporation to revalue any new patents acquired prior to March 1, 1913, and unexpired on that date. Depreciation on such revaluation would be allowed.

It is legitimate and legal to make changes in bookkeeping methods and take advantage of deductions under laws which impose high tax rates, irrespective of the taxpayers' former methods.

LIFE OF PATENT OR TRADE-MARK IN FOREIGN COUNTRIES.[75]—

Country	Term of Patent	Term of Trade-Mark
Great Britain	16 years. Extended from 14 years by act of Parliament, 1919	14 years renewable.
France	5, 10, or 15 years from filing of application	15 years renewable.
Germany	15 years from next day after filing	10 years renewable.
Russia	15 years	1 to 10 years.
Canada	18 years	General unlimited; special 25 years renewable.
Australia	14 years	14 years renewable.
Austria	15 years	10 years renewable.
Switzerland	10 years for chemical process. 15 years from filing.	20 years renewable.
Sweden	15 years from filing	10 years renewable.
Denmark	15 years	10 years renewable.
United States	17 years	20 years renewable.

Patterns, drawings, models, designs, etc.—The difficulty which the accountant encounters in the proper valuation of such patterns as are successful is to persuade proprietors to accept valuations which are reasonably conservative. Where patterns are used for stock or regular output, their value depends upon their life and upon the probability of renewed use. Where they are acquired or made for special jobs, their residual value is small, and their life should be considered coextensive with the life of the jobs themselves. In every case

[75] C. B. 3, page 169; O. D. 721.

items such as these should be looked upon with suspicion, and convincing proof must be adduced before placing any material sum on their account as an asset. An auditor often meets with strong opposition in his efforts to reduce these items to reasonable amounts, for they represent the skill and often the affections of the proprietors, who dislike to see their value depreciated on the books. But the public demand is fickle, and patterns must be made to suit the changing taste. Even what appear to be standard patterns for stable businesses often change rapidly. Engineers make almost as many alterations in their "styles" as do milliners. When the demand ceases most of the old patterns should be scrapped. This rule applies to hardware designs as well as to patterns for women's dresses.

An analysis of the sales, showing articles made from specific patterns, is evidence that the patterns have a life beyond the year in which their cost was incurred. Such an analysis is particularly useful in those cases in which repeat orders are received sometimes several years after the original sale was made. Patterns used only rarely are often scrapped and new ones made as occasion requires. In such instances the *drawing* has the value.

The charges against this account are usually cumulative, i.e., they follow the output almost automatically, thus indicating that most of the old patterns, etc., are obsolete or have been discarded. Usually depreciation charges should equal the annual expenditures for new patterns, etc. Wherever feasible, the conservative course is to write down the book value to $1.

Earlier regulations[76] required that expenditures for successful patterns, etc., must be capitalized and specifically written off, the charge being based on their effective life. The regulations under both the 1918 and 1921 laws give to the taxpayer the option of charging off such items as expenses or of capitalizing them.

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[76] Reg. 33, 1918, Arts. 175-177.

REGULATION. A taxpayer who has incurred expenses in his business for designs, drawings, patterns, models, or work of an experimental nature calculated to result in improvement of his facilities or his product, may at his option deduct such expenses from gross income for the taxable year in which they are incurred or treat such articles as a capital asset to the extent of the amount so expended. In the latter case, if the period of usefulness of any such asset may be estimated from experience with reasonable accuracy, it may be the subject of depreciation allowances spread over such estimated period of usefulness. The facts must be fully shown in the return or prior thereto to the satisfaction of the Commissioner. Except for such depreciation allowances no deduction shall be made by the taxpayer against any sum so set up as an asset except on the sale or other disposition of such assets at a loss or on proof of a total loss thereof. (Art. 168.)

An appraisal made in 1920 as of March 1, 1913, was accepted by the Treasury for depreciation purposes.[77]

Printing.—The depreciation of printing plants is about the same as that in the textile industry (see page 1061) with the exception of type, printers' tools, electrotypes, plates, etc., on which from 10 to 25 per cent should be applied annually. Some authorities recommend a rate as high as 25 per cent on type and electroplates.

Professions—physician's claims for depreciation.—In New York a physician made the following claims for depreciation which were allowed:

Residence, brick construction, on part occupied as offices only	5%
Automobile	20
Books	20
Instruments	25
Office furniture	20
Country residence, wood construction, on part occupied as offices only	10

RADIUM—NO DEPRECIATION ALLOWED.—

RULING. Since the full life of radium has been scientifically estimated at such an extended period and since no appreciable de-

[77] C. B. 3, page 173; A. R. R. 272.

preciation results from its continued use as a therapeutic agent, the depreciation occurring during the lifetime of any individual owner is practically negligible. It is held, therefore, that radium which is used as a therapeutic agent is not subject to depreciation for income tax purposes and its cost must be treated as a capital expenditure. The return of capital will be realized upon its sale or other disposition. (C. B. 4, page 178; O. D. 837.)

Railroad sidings.—

RULING. A railroad company constructed a siding to connect the property of the M Company with its railroad. A part of the siding on land of the M Company is owned by the M Company. The cost was borne by the M Company and is recoverable through depreciation allowances.

A part of the siding on land of the railroad company is owned by the railroad company. The cost was borne by the M Company and is a business expense deductible for the year in which it was incurred.[78] . . . . (C. B. 5, page 151; O. D. 1019.)

Shipping industry.—Prior to 1920 satisfactory American rates applicable to this industry were not available. The rates claimed by ship-owners were far from uniform.[79]

BULK FREIGHT STEAMSHIPS—GREAT LAKES.—Three per cent is held to be a reasonable allowance for this class of vessel.[80]

Some of the United States Shipping Board vessels were operated under charters which gave the charterers the option to purchase the vessels. The initial cost of reconditioning, which was borne by the charterers, was applied on the purchase price, less depreciation at the rate of 7½ per cent per annum.

SHIPS REQUISITIONED BY SHIPPING BOARD.—

RULING. Ships in process of construction under contract were requisitioned by the Shipping Board, completed, and then reconveyed to the company from which they were requisitioned for an amount in excess of the contract price of the ships. Held, that the

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[78] See also I-30-427; A. R. R. 1008.

[79] For British rates see *Income Tax Procedure,* 1920, pages 733-735.

[80] C. B. 2, page 139; A. R. R. 27. See C. B. I-1, page 161; A. R. R. 963, which modified A. R. R. 27 so as to permit more liberal obsolescence deductions. Also see page 1083 *et seq.*

entire cost of the ships is a capital expenditure recoverable by allowances for depreciation, obsolescence, and amortization to the extent allowable under the Revenue Act of 1918 and Regulations 45, and that the excess of the cost over the contract price is not deductible as a loss or a business expense. (C. B. 4, page 179; O. D. 851.)

STEAM SCHOONERS.—Depreciation of steam schooners engaged in the coastwise lumber trade was fixed at 5 per cent.[81]

Sprinkler system.—When the sprinkler system is purchased under a conditional sales agreement, the portion of each instalment payment representing interest on deferred payments should be deducted as an expense. Depreciation should also be deducted, at 5 per cent, on the full capital value represented by the present worth of the total instalment payments to be made.[82]

Soap industry.—Depreciation in this industry is about the same as in chemical factories.[83]

Textile industry.—In the textile industry the depreciation of buildings is somewhat heavy owing to the vibration of the machines. The rate assigned to the machinery is often made high because of the likelihood of obsolescence and the introduction of new appliances. The average depreciation provides for about 3 per cent on the building, if of fireproof brick construction, and 6 per cent on the machinery.

There is a wide variance in practice as to the depreciation of textile machinery. In some districts where machines, perhaps fifty years old, are giving good service today, the disposition is toward low rates. In this industry the continual renewal of many different parts of a loom serves to reduce the depreciation rate. Experience proves, however, that some of

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[81] C. B. 3, page 168; A. R. R. 279.
[82] See page 848.
[83] See page 1035.

these old machines are "pets," while more modern machines which have been worn out and replaced several times in the same period are forgotten. A writer in the *Textile World Record* suggested 3¾ per cent as a rate for cotton and woolen machinery, including spinning and weaving machinery. A large Boston firm of textile mill engineers uses these rates:

Woolen and worsted machinery	2-2½%
Cotton machinery	3
Dyeing and similar machinery subjected to acid fumes, etc.	5

A very recent publication[84] suggests somewhat higher rates than the foregoing. The rates recommended vary from 4 to 6⅔ per cent for the various kinds of machines falling in the general categories of woolen and cotton mill machinery.

Timber industry.[85]—Specific provision is made in the regulations regarding depreciation of property used in a timber project when the probable life of the asset exceeds that of the project itself. The same rules as apply in the case of mining, oil and gas projects apply here, viz., that the life of the project shall be considered a limiting factor, due allowance being made for salvage value.[86]

DEPRECIATION OF TIMBER PLANTS, IMPROVEMENTS AND EQUIPMENT.—

REGULATION. In the case of a timber property held for future operation by an owner having no substantial income from the property or from other sources, all expenditures for administration, protection, and other carrying charges prior to production on a normal basis shall be charged to capital account; after such a property is on a normal production basis such expenditures shall be treated as current operating expenses. In case a taxpayer, who has a substantial income from other sources, owns a timber property which is not yet on a normal production basis he may, at his option, charge such expenditures with respect to such timber property to capital, or treat them as current operating expenses, but whichever system is adopted

[84] *Cost Control for Textile Mills,* by Eugene Szepesi (1922).
[85] For regulations relating to depletion of timber lands, see Chapter XXXVIII.
[86] Bulletin "F," pages 31, 32.

must be followed until permission to change to the other system is secured from the Commissioner. In the case of timber operations all expenditures prior to production for plants, improvements, and equipment, and thereafter all major items of plant and equipment shall be charged to capital account for purposes of depreciation. After a timber operation has been developed and equipped and has reached its normal output capacity, the cost of additional minor items of equipment and the cost of replacement of minor items of worn-out and discarded plant and equipment may be charged to current operating expenses, ... unless the taxpayer elects to write off such expenditures through charges for depreciation; however, the method adopted must be followed consistently from year to year. (Art. 231.)

Some of the factors which affect the rate at which physical plant should be written off are: impossibility of securing additional timber in the same locality, expenditures for bridges and roads to reach more inaccessible tracts held for future exploitation, increased freight rates making exploitation unprofitable, and others which study of a specific case will develop. Information of this character is required in that section of form T dealing with depreciation.

REGULATION. The cost or value as of March 1, 1913, as the case may be, of development not represented by physical property having an inventory value, and such cost or value of all physical property which has not been deducted and allowed as expense in the returns of the taxpayer, shall be recoverable through depreciation. It shall be optional with the taxpayer, subject to the approval of the Commissioner, (*a*) whether the cost or value, as the case may be, of the property subject to depreciation shall be recovered at a rate established by current exhaustion of stumpage, or (*b*) whether the cost or value shall be recovered by appropriate charges for depreciation calculated by the usual rules for depreciation or according to the peculiar conditions of the taxpayer's case by a method satisfactory to the Commissioner. In no case may charges for depreciation be based on a rate which will extinguish the cost or value of the property prior to the termination of its useful life. Nothing in these regulations shall be interpreted to mean that the value of a timber plant and equipment, so far as it is represented by physical property having an inventory value, may be reduced by depreciation deductions to a sum below the value of the salvage when the plant and equipment shall have become obsolete or worn out or shall have been abandoned, or that any part of the value of cut-over land may be recoverable through depreciation. (Art. 232.)

In the computation of depreciation it is recognized that "the reasonable expectation of the economic life" may increase the amount of depreciation. This principle also applies to depletion charges.[87]

Tools, jigs, dies, etc.—As a rule the practice of depreciating small tools by means of a percentage cannot be followed satisfactorily. So many such tools are used up, lost, or stolen, that an inventory should be made periodically and all the tools on hand should then be revalued. If this plan is followed for several years and a trustworthy rate of depreciation is secured, it may be feasible to omit the revaluation for a year or two, applying the rate previously ascertained. The tax commissioner of one of the states has adopted rates varying from 25 to 50 per cent or, as an alternative, the entire cost of replacements.

In many manufacturing concerns the item of tools, jigs, dies, etc., not standard equipment, is a large one and the tendency is to overvalue it. Heavy depreciation should be applied, because most of such equipment is made or adapted for special uses, and the inevitable changes in types and styles of production require corresponding changes in the tools. As stated heretofore, under "Patterns, drawings, models, designs, etc.," (page 1057), the book value should be written down very rapidly. The minimum rate should not be less than 20 per cent.

Edward N. Hurley, former chairman of the Federal Trade Commission, urges that special tools be charged off practically at once, and states that the neglect to depreciate this account rapidly enough has been responsible for many failures.

Typewriters.—In the average office the life of a good typewriter, if properly cared for, is from three to five years. In some offices the machines are turned in and new ones purchased every two or three years. Such typewriters are repaired and resold, and are used several years more by those

[87] See page 1170 *et seq.*

who buy them second-hand. Repairs are not profitable after the machines have been used from six to eight years. An annual depreciation rate of 20 per cent is conservative and reasonable.

Uniforms—naval and military.—Under the provisions of article 291 of Regulations 62,[88] the cost of an officer's uniform is not deductible from income, as it is deemed to take the place of clothing required in civilian life. It has now been decided that for the same reason depreciation cannot be claimed on uniforms.

RULING. A deduction may not be claimed to cover depreciation in the value of uniforms by an officer of the Navy. . . . . (C. B. 5, page 154; Digest A. R. R. 594.)

A taxpayer claimed the same allowance as is granted in the case of theatrical costumes,[89] on the ground that uniforms should be classed as business assets. The Committee on Appeals and Review held, however, that since they may be worn on other than official occasions, such as weddings, receptions, etc., they are not used exclusively for "business purposes."

Wagons, trucks, etc.—In the case of wagons it will be found that 8 to 10 per cent per annum is an ample allowance, provided that all repairs, renewals of parts, and maintenance are charged to operating expenses.

Wood-working industry.—On buildings and equipment in the wood-working industry the depreciation is low—about 2 or 3 per cent on buildings and 6 per cent on equipment.

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[88] See page 811.
[88] See Art. 162, quoted on page 1037.

TABLE OF DEPRECIATION RATES

For treatment of specific items of depreciable property, see preceding pages.

NOTE: The inclusion of any suggested rate in the following table does not necessarily indicate that the author of this book approves of such rate. In general, however, he believes the rates to be reasonable. Rates marked by an asterisk (*) are stated by the organizations publishing them to have been submitted to, and approved by, the Bureau of Internal Revenue.

ITEM	RATE PER CENT	AUTHORITY	PUBLICATION
Adding machines	20	Nicholson & Rohrbach	Cost Accounting
Agricultural machinery	10	Australia Fed. Income Tax	
	6–12	Montgomery, R. H.	Auditing, Theory & Practice, Vol. I
Alternators	5	Grunsky, C. E.	Valuation, Deprec. & Rate Base
	4	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F
Annealing pits	7½	Assn. Mfrs. Chilled Car Wheels	Uniform Cost Accounting System
Anvils	5–10	Am. Foundrymen's Assn.	Standard Foundry Costs
Apartment houses	3	U. S. Dist. Court (N. Y.)	Cohen v. Lowe, 234 Fed. 474
Asphalt pavements	5–6⅔	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F
	8⅓–10	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Automobiles:			
Motor cars	25–40	Dana, Richard T.	Handbook of Construction Plant
	25	Philadelphia Controller	Manual of Accounting
Motor trucks	20	Piez, Chas.	Trans. A. S. M. E., 1916
	20	Belt, R. E.	Foundry Cost Accounting
	25	Associated General Contractors	Bulletin, February 26, 1921
Barrels, steel tumbling	10	Am. Foundrymen's Assn.	Standard Foundry Costs
	15	Am. Malleable Castings Assn.	Cost Accounting Methods
Batteries, storage	5–11	Cravens, Geo. A.	Electrical Review, 1910
	5–6⅔	Floy, Henry	Valuation of Public Utilities
	3–10	Gillette & Dana	Mech. & Elect. Cost Data
Belting	5	Wisconsin P. S. Com.	Reports
	5–12½	Grunsky, C. E.	Valuation, Deprec. & Rate Base
	12½	Assn. Mfrs. Chilled Car Wheels	Uniform Cost Accounting System
	4–10	Kimball, D. S.	Cost Finding
Bindery machinery	10	A. E. Davis	How to Find Costs in Printing
Blowers:			
Centrifugal	6⅔	Gillette & Dana	Mech. & Elect. Cost Data
Gas plant	5–6⅔	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Boilers, general	6⅔*	Portland Cement Industry	Cost Accounting
	3⅓–6⅔	Am. Waterworks, Assn.	Reports

	2½–10	Gillette & Dana	Mech. & Elect. Cost Data
Fire tube	7½	Am. Institute of Accountants	Special Bulletin No. 1
Water tube	5	Do.	Do.
Bottle machinery:			
Feeders and flow devices...	12½	Natl. Bottle Mfrs. Assn.	Uniform Cost System
Lehrs, conveyors, etc......	10	Do.	Do.
Mixers	10	Do.	Do.
Owen's machines	12½	Do.	Do.
Semi-automatics	20	Do.	Do.
Box (wooden) machinery.......	10	Natl. Assn. Box Mfrs.	Cost Finding and Acct. Plan
Bridges:			
Masonry	1	Bryan, W. H.	Eng. News, 1908
Steel	3	Do.	Do.
	4–5	Gillette & Dana	Mech. & Elect. Cost Data
Wooden	5–6⅔	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F
	10	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Buckets, excavating	18¾	Associated General Contractors	Bulletin, February 26, 1921
Buildings:			
Brick	3	Piez, Chas.	Trans. A. S. M. E., 1916
	4	Gillette & Dana	Mech. & Elect. Cost Data
	2–7	Bryan, W. H.	Eng. News, 1908
Concrete	1½	Wisconsin R. R. Com.	Reports
	2	Grunsky, C. E.	Valuation, Deprec. & Rate Base
	4	U. S. Internal Revenue	Manual for the Oil & Gas Industry, 1921
Fireproof, modern	2½	Grunsky, C. E.	Valuation, Deprec. & Rate Base
	2–4	Foster, H. A.	Eng. Valuation of Public Utilities
Frame	5	Mucklow, Walter	Real Estate Accounts
	3–6	Kimball, D. S.	Cost Finding
Cables:			
Aerial, lead covered........	8⅓	Wisconsin R. R. Com.	Reports
	6⅔–10	Grunsky, C. E.	Valuation, Deprec. & Rate Base
	6⅔–8⅓	Gillette & Dana	Mech. & Elect. Cost Data
Underground, lead covered..	4–5	Wisconsin R. R. Com.	Reports
	3⅓	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F
Underground, main.........	5	C. W. McKay	Telephone Rates and Values
Underground, subsidiary....	8⅓	Do.	Do.
Cables and haulage for mines...	50	Schwertner, F.	Coal Age, September 15, 1921
Cableway	11*	Portland Cement Industry	Cost Accounting
Canning machinery	15–20	Natl. Canners' Assn.	Special Bulletin No. 3
Car bodies	4–6⅔	Floy, Henry	Valuation of Public Utilities
	5–8	Gillette & Dana	Mech. & Elec. Cost Data
Car trucks	3½–5	Floy, Henry	Valuation of Public Utilities
	3⅓–6⅔	Grunsky, C. E.	Valuation, Deprec. & Rate Base

TABLE OF DEPRECIATION RATES—CONTINUED

ITEM	RATE PER CENT	AUTHORITY	PUBLICATION
Cars:			
Elec. and street railway....	3⅓–5	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F
	5–8½	Floy, Henry	Valuation of Public Utilities
Mine	25	Schwertner, F.	Coal Age, September 15, 1921
Steel railroad:			
Freight	2–3⅓	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Passenger	2½–3	Do.	Do.
Oil tank	5	U. S. Internal Revenue	Manual for the Oil & Gas Industry, 1921
Carts, hand drawn.............	20	Philadelphia Controller	Manual of Accounting
Chimneys:			
Brick	3–7	Gillette & Dana	Mech. & Elec. Cost Data
Steel	10	Do.	Do.
Chutes, loading and unloading....	10–25	Am. Foundrymen's Assn.	Standard Foundry Costs
Clinker grinding machinery.....	8⅓*	Portland Cement Industry	Cost Accounting
Compressors, air	6	Piez, Chas.	Trans. A. S. M. E., 1916
	7½	Belt, R. E.	Foundry Cost accounting
Concrete mixers	15	Associated General Contractors	Bulletin, February 26, 1921
Condensers	4–5	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F
	3⅓–10	Gillette & Dana	Mech. & Elec. Cost Data
Condensers and scrubbers (gas plant)	3⅓	Do.	Do.
Conduits:			
Cast iron	1⅓–2	Do.	Do.
Clay	2	Foster, H. A.	Eng. Valuation of Pub. Utilities
Wooden	5	Do.	Do.
	2½–4	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Wrought iron or steel......	3⅓–5	Gillette & Dana	Mech. & Elec. Cost Data
Containers:			
Barrels, steel oil...........	14 2/7	U. S. Internal Revenue	Manual for the Oil & Gas Industry, 1921
Cans, milk, ash, feed......	33⅓	Philadelphia Controller	Manual of Accounting
Casks	10	Various	
Converters, rotary	3–6⅔	Cravens, G. A.	Elec. Review, 1910
	4–5	Gillette & Dana	Mech. & Elect. Cost Data
Conveyors, general	10–20	Am. Foundrymen's Assn.	Standard Foundry Costs
Belt or bucket..............	37½	Associated General Contractors	Bulletin, February 26, 1921
Coal or ash	10	Floy, Henry	Valuation of Public Utilities
	5	Atl. Coast Ship Builders' Assn.	Cost Accounting Manual
Core ovens and apparatus:			
Brick	10	Belt, R. E.	Foundry Cost Accounting
Steel	7½	Do.	Do.

Core machines	15	Do.	Do.
	15	Am. Malleable Castings Assn.	Cost Accounting Methods
Cotton mill machinery	4–6⅔	Szepesi, Eugene	Cost Control for Textile Mills
Cranes:			
General	2	Gillette & Dana	Mech. & Elect. Cost Data
	2–6⅔	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Locomotive	9½	Associated General Contractors	Bulletin, February 26, 1921
	10	Assn. Mfrs. Chilled Car Wheels	Cost Accounting System
Traveling	7½	Belt, R. E.	Foundry Cost Accounting
	4½	Piez, Chas.	Trans. A. S. M. E., 1916
Cross-arms, electric light and power	10	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F
	8⅓–12½	Gillette & Dana	Mech. & Elect. Cost Data
Crucibles	7½	Belt, R. E.	Foundry Cost Accounting
Crusher, rock	12½	Associated General Contractors	Bulletin, February 26, 1921
	7*	Portland Cement Industry	Cost Accounting
Cupolas	5	Belt, R. E.	Foundry Cost Accounting
	10	Assn. Mfrs. Chilled Car Wheels	Cost Accounting System
Derricks:			
Steel	7½	Associated General Contractors	Bulletin, February 26, 1921
Wooden	15	Do.	Do.
Dies	25–50	Wood, C. E.	Accounting Methods for Industrials
	33⅓	Electrical Mfg. Industry	Accounting and Cost System
Dredges	9*	Portland Cement Industry	Cost Accounting
Drills:			
Presses	5–7½	Am. Foundrymen's Assn.	Standard Foundry Costs
Traction well	12½	Associated General Contractors	Bulletin, February 26, 1921
Tripod or jackhammer	18¾	Do.	Do.
Tripod	14*	Portland Cement Industry	Cost Accounting
Tunnel carriage	15	Associated General Contractors	Bulletin, February 26, 1921
Well	11*	Portland Cement Industry	Cost Accounting
Dry dock, floating	5	Atl. Coast Shipbuilders' Assn.	Cost Accounting Manual
Dryers, rotary and upright	9*	Portland Cement Industry	Cost Accounting
Dust collecting system	7½	Am. Foundrymen's Assn.	Standard Foundry Costs
	10	Am. Malleable Castings Assn.	Cost Accounting Methods
Dwellings:			
Brick	1½–2½	Tiffany, H. S.	Digest of Depreciation
Frame	2½–4½	Do.	Do.
	3	Gillette & Dana	Mech. & Elect. Cost Data
Dyeing equipment	15–20	Am. Dyers Institute	Cost Accounting Methods
Elevators, grain	3	Gillette & Dana	Mech. & Elect. Cost Data
Engines:			
Gas	5	Belt, R. E.	Foundry Cost Accounting
	6⅔–10	Kimball, D. S.	Cost Finding
	6⅔	Gillette & Dana	Mech. & Elect. Cost Data

TABLE OF DEPRECIATION RATES—CONTINUED

Item	Rate Per cent	Authority	Publication
Steam	5–10	Gillette & Dana	Mech. & Elect. Cost Data
	5	Belt, R. E.	Foundry Cost Accounting
	4–6.6	Cravens, G. A.	Elec. Review, 1910
Excavators:			
Cableway	12½	Associated General Contractors	Bulletin, February 26, 1921
Trench	15	Do.	Do.
Extractors, oil	5	Am. Foundrymen's Assn.	Standard Foundry Costs
Fans, ventilating	7½	Do.	Do.
Fences:			
Wire	7½	Belt, R. E.	Foundry Cost Accounting
Wooden	10	Do.	Do.
Fire extinguishers	10	Philadelphia Controller	Manual of Accounting
Fire protection apparatus	8⅓	Grunsky, C. E.	Valuation, Deprec. & Rate Base
	10	Am. Foundrymen's Assn.	Standard Foundry Costs
Flasks:			
Aluminum	10	Am. Foundrymen's Assn.	Standard Foundry Costs
Cast Iron	33⅓	Do.	Do.
Snap steel	12½	Do.	Do.
Flour mill machinery	4	Indiana Millers' Assn.	Modern Miller, October 15, 1921
Forges	5	Am. Foundrymen's Assn.	Standard Foundry Costs
Fuel oil equipment	4	Chicago Traction Val. Com.	Reports
Furnaces:			
Air	7½	Belt, R. E.	Foundry Cost Accounting
Annealing	10	Am. Malleable Castings Assn.	Cost Accounting Methods
Blast	5	H. S. Tiffany	Digest of Depreciation
Electric or open hearth	10	Belt, R. E.	Foundry Cost Accounting
Glassware	5	Illuminating Glassware Guild	Salier's Depreciation, 1922
Furniture and fixtures	10–20	Kester, R. B.	Accounting Theory and Practice, Vol. II
	5–8	Gillette & Dana	Mech. & Elect. Cost Data
Gas mains, city	10	U. S. Internal Revenue	Manual for the Oil and Gas Industry, 1921
Generators	3⅓–8	Gillette & Dana	Mech. & Elect. Cost Data
	5–10	Grunsky, C. E.	Valuation, Deprec. & Rate Base
	4–8.3	Cravens, G. A.	Elec. Review, 1910
	7½	Belt, R. E.	Foundry Cost Accounting
	6¼*	Portland Cement Industry	Cost Accounting
Glassware, mixers	10	Illuminating Glassware Guild	Salier's Depreciation, 1922
Machinery	10	Do.	Do.
Grinders, air or electric drive	20	Am. Foundrymen's Assn.	Standard Foundry Costs
Hammers:			
Drop	10	Belt, R. E.	Foundry Cost Accounting

	4½	Piez, Chas.	Trans. A. S. M. E., 1916
Pneumatic	15	Clapham, F. T.	Mechanical World, 1917
Steam	10	Nicholson & Rohrbach	Cost Accounting
Harness	12½	Philadelphia Controller	Manual of Accounting
	16.2*	Natl. Assn. of Ice Industries	
Heating and ventilating system..	5	Piez, Chas.	Trans. A. S. M. E., 1916
	4	Am. Foundrymen's Assn.	Standard Foundry Costs
	6	Assn. Mfrs. Chilled Car Wheels	Cost Accounting System
Heating systems, steam	5	Belt, R. E.	Foundry Cost Accounting
Hoists, various	7½–12½	Various	Accountants' Index
Horses	5–20	Gillette & Dana	Mech. & Elect. Cost Data
	10	Philadelphia Controller	Manual of Accounting
	15.4*	Natl. Assn. of Ice Industries	
Hose, fire	20	Assn. Mfrs. Chilled Car Wheels	Cost Accounting System
Hydrants	2–3	Metcalf, Leonard	Trans. A. S. M. E., 1916
Ice cream machinery	12½	Roszell, L. W.	Ice Cream Trade Journal, March, 1922
Ice cream tubes, cases, cabinets.	20	Do.	Do.
Ice houses, wooden for natural ice	6.4*	Natl. Assn. of Ice Industries	
Ice harvesting and hoisting machinery, including conveyors, merrimacs and basin saws, elevators and power plants..	9½*	Do.	
Ice manufacturing:			
Electric driven	7.3*	Do.	
Steam driven	7.1–7.6*	Do.	
Injectors, boiler	10	Am. Foundrymen's Assn.	Standard Foundry Costs
Jigs	33⅓	Electrical Mfg. Industry	Accounting and Cost System
Kilns, general	7.7*	Portland Cement Industry	Cost Accounting
Continuous heat	7½	Am. Institute of Accountants	Special Bulletin No. 9
Periodic heat	10	Do.	Do.
Laboratory equipment	10	Belt, R. E.	Foundry Cost Accounting
Lathes, steel	10	Do.	Do.
Laundry equipment	8⅓	Philadelphia Controller	Manual of Accounting
Laundry machinery and equipment	10	Laundry Owners' Nat. Assn.	Standardized System of Cost Accounting
Lockers, steel	5	Am. Foundrymen's Assn.	Standard Foundry Costs
Locomotives, steam or electric..	6⅔	Nicholson & Rohrbach	Cost Accounting
Quarry	7.7*	Portland Cement Industry	Cost Accounting
Machinery, general	7½–10	Woods, C. E.	Accounting Methods for Industrials
	5–10	Belt, R. E.	Foundry Cost Accounting
	4	Grunsky, C. E.	Valuation Deprec. & Rate Base
	12½	Gillette & Dana	Mech. & Elect. Cost Data
Meters:			
Electric	5	Am. Foundrymen's Assn.	Standard Foundry Costs
	6⅔–8	Gillette & Dana	Mech. & Elect. Cost Data

TABLE OF DEPRECIATION RATES—Continued

Item	Rate Per cent	Authority	Publication
Meters (Cont.)			
Gas	4	Gillette & Dana	Mech. & Elect. Cost Data
Natural gas	20	U. S. Internal Revenue	Manual for the Oil and Gas Industry, 1921
Oil	7½	Am. Foundrymen's Assn.	Standard Foundry Costs
Steam flow	10	Do.	Do.
Water	5	Gillette & Dana	Mech. & Elect. Cost Data
Milling machines	10	Belt, R. E.	Foundry Cost Accounting
Mining machines	12½–20	Schwertner, F.	Coal Age, September 15, 1921
Molding equipment	15–20	Am. Malleable Castings Assn.	Cost Accounting Methods
	15	Assn. Mfrs. Chilled Car Wheels	Cost Accounting System
Molds	33⅓	Electrical Mfg. Industry	Accounting and Cost System
Motors, electric	5	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F
	12½	Associated General Contractors	Bulletin, February 26, 1921
	4–8.3	Cravens, G. A.	Elect. Review, 1910
	7*	Portland Cement Industry	Cost Accounting
Oil separators	7½	Belt, R. E.	Foundry Cost Accounting
Ovens:			
Coke:			
Bee-hive	10	Schwertner, F.	Coal Age, September 15, 1921
By-products	6⅔	Do.	Do.
Core	10	Assn. Mfrs. Chilled Car Wheels	Cost Accounting System
Patterns	75–100	Piez, Chas.	Trans. A. S. M. E., 1916
	20–33⅓	McIntosh, Robt.	Reference Book of Accounting (2nd Ed.)
Pavements:			
Asphalt	7	Foster, H. A.	Eng. Valuation of Public Utilities
Brick	4½	Gillette & Dana	Mech. & Elect. Cost Data
Granite	4⅘–6¼	Grunsky, C. E.	Valuation Deprec. & Rate Base
Macadam	5½–12½	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F.
Wood block	3⅓–5	Do.	Do.
Pile drivers:			
Steam	10	Atl. Coast Shipbuilders' Assn.	Cost Accounting Manual
	9½	Associated General Contractors	Bulletin, February 26, 1921
Track	7½	Do.	Do.
Piping, general	4	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F.
	4–8.3	Cravens, G. A.	Elect. Review, 1910
	10	Kent, William	Cost Accounting for Factories
Air	5	Am. Foundrymen's Assn.	Standard Foundry Costs
Fuel-oil	5–10	Do.	Do.
Sewer and drainage	6	Machinery Builders' Society	Accounting and Cost System
Water and steam	5–7½	Am. Foundrymen's Assn.	Standard Foundry Costs
Plumbing	3⅓–4	Philadelphia Controller	Manual of Accounting

Poles:			
Concrete, reinforced	2	Barker, Harry	Public Utility Rates
Iron or steel set in concrete.	3⅓–6⅔	Foster, H. A.	Eng. Valuation of Public Utilities
Wood	5½–10	Do.	Do.
Power plant equipment	7½	Belt, R. E.	Foundry Cost Accounting
Presses:			
Drill	10	Do.	Do.
Punch	4½	Piez, Chas.	Trans. A. S. M. E., 1916
Printing trade machinery:			
Bed, platen and cylinder embossers	15	Folding Box Mfrs. Natl. Assn.	Uniform Cost System
Box department, paper	10	Bureau of Envelope Mfrs.	Revised Cost Manual
Clasp and tension	15	Do.	Do.
Cutters, straight and die	5	Folding Box Mfrs. Natl. Assn.	Uniform Cost System
	7½	Bureau of Envelope Mfrs.	Revised Cost Manual
Cutters and creasers:			
Cylinder	7½–10	Folding Box Mfrs. Natl. Assn.	Uniform Cost System
Platen	7½–10	Do.	Do.
	10	Bureau of Envelope Mfrs.	Revised Cost Manual
Electro foundry	7½–10	Folding Box Mfrs. Natl. Assn.	Uniform Cost System
Folding, plunger and open-end	10	Bureau of Envelope Mfrs.	Revised Cost Manual
Gluers, automatic	7½	Folding Box Mfrs. Natl. Assn.	Uniform Cost System
Gummers, machine	10	Bureau of Envelope Mfrs.	Revised Cost Manual
Ink grinders	5	Folding Box Mfrs. Natl. Assn.	Uniform Cost System
Presses:			
Flat and rotary	7½–10	Do.	Do.
Offset	10–12½	Do.	Do.
Pug mills, grinding pans, etc.	10	Am. Institute of Accountants	Special Bulletin No. 9
Pumps	5–8⅓	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F.
	5	Belt, R. E.	Foundry Cost Accounting
Rails	8	Gillette & Dana	Mech. & Elect. Cost Data
	3⅓–10	Bay State Rate Case	Pub. Util. Reports annotated, 1916 F.
	4–6⅔	Grunsky, C. E.	Valuation Deprec. & Rate Base
Refinery equipment:			
Distillation	15	U. S. Internal Revenue	Manual for the Oil and Gas Industry, 1921
Lubricating plant	10	Do.	Do.
Miscellaneous	10	Do.	Do.
Pipes and fittings	12	Do.	Do.
Power plant	10	Do.	Do.
Storage	8	Do.	Do.
Rolling stock, railroad	5–7	Foster, H. A.	Eng. Valuation of Public Utilities
	5–8½	Chicago Traction Com.	Report
Sand blast barrels and tables	25	Belt, R. E.	Foundry Cost Accounting
Sand mixers	15	Do.	Do.
Sawmill machinery	7½	British Inland Revenue	
Saw rigs	18¾	Associated General Contractors	Bulletin, February 26, 1921

TABLE OF DEPRECIATION RATES—CONTINUED

Item	Rate Per cent	Authority	Publication
Scales	15	Assn. Mfrs. Chilled Car Wheels	Cost Accounting System
Sewers	2½	Belt, R. E.	Foundry Cost Accounting
Shafting, pulleys, etc.	4	Philadelphia Controller	Manual of Accounting
	4¾	Kimball, D. S.	Cost Finding
	10	Assn. Mfrs. Chilled Car Wheels	Cost Accounting System
Ships, steel or iron:			
Inland water	2½	Gillette & Dana	Mech. & Elect. Cost Data
Ocean-going	3	Do.	Do.
Shop equipment	5–15	Cravens, G. A.	Elect. Review, 1910
Shovels:			
Electric	10¾	Associated General Contractors	Bulletin, February 26, 1921
Gasoline	18¾	Do.	Do.
Steam	12½	Do.	Do.
	9*	Portland Cement Industry	Cost Accounting
Sprinkler system	3–7½	Am. Foundrymen's Assn.	Standard Foundry Costs
	5	Belt, R. E.	Foundry Cost Accounting
Stacks:			
Brick	5	Do.	Do.
	3	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Steel	4–10	Am. Waterworks Assn.	Reports
	10	Gillette & Dana	Mech. & Elect. Cost Data
Steam power plants	5	Do.	Do.
Steam separators	10	Am. Foundrymen's Assn.	Standard Foundry Costs
Steam traps	7½	Do.	Do.
Stokers:			
Fixed parts	5	Chicago Traction Val. Com.	Reports
Moving parts	20	Do.	Do.
Stokers and equipment	5	Brewer, A. F.	Combustion, February, 1922
Superheaters	3⅓	Do.	Do.
Switch boards	8⅓	Philadelphia Controller	Manual of Accounting
Electric companies	4½	Foster, H. A.	Eng. Valuation of Public Utilities
	2–6⅔	Gillette & Dana	Mech. & Elect. Cost Data
Telephone	10–12½	Foster, H. A.	Eng. Valuation of Public Utilities
	8⅓–12½	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Switchboard and instruments	2–8.3	Cravens, G. A.	Elect. Review, 1910.
Tanks:			
Steel	6⅔	Gillette & Dana	Mech. & Elect. Cost Data
	4½	Piez, Chas.	Trans. A. S. M. E., 1916
Wooden	10	Do.	Do.
	8⅓	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Taxicabs	33⅓	Am. Institute of Accountants	Special Bulletin No. 9
Telephone:			
Central office equipment	10	McKay, C. W.	Telephone Rates and Values
Subscriber's station apparatus	11–12½	Do.	Do.
Testing machines, tensile	5	Belt, R. E.	Foundry Cost Accounting

Tools:			
Machine	5	Foster, H. A.	Eng. Valuation of Public Utilities
Small	10	Floy, Henry	Valuation of Public Utilities
	50	Piez, Chas.	Trans. A. S. M. E., 1916
Tractors:			
Caterpillar	15	Associated General Contractors	Bulletin, February 26, 1921
Electric, industrial	25	Belt, R. E.	Foundry Cost Accounting
	10	Am. Foundrymen's Assn.	Standard Foundry Costs
Transformers	4½	Foster, H. A.	Eng. Valuation of Public Utilities
	6⅔	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Turbines:			
Steam	3–5	Cravens, G. A.	Elect. Review, 1910
	2½–5	Gillette & Dana	Mech. & Elect. Cost Data
	3⅓–6⅔	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Water	2–3⅓	Do.	Do.
	3⅓	Gillette & Dana	Mech. & Elect. Cost Data
Type	25	United Typothetae	Standard Accounting System for Printers
	33⅓	Denham, R. S.	Manual of Cost Eng. & Estimating
	10	Various English Authorities	
Typewriters	20	Nicholson & Rohrbach	Cost Accounting
Underwear mill machinery	6⅔–10	Szepesi, Eugene	Cost Control for Textile Mills
Valves, general	6	Gillette & Dana	Mech. & Elect. Cost Data
	4	Philadelphia Controller	Manual of Accounting
Gate:			
Brass	5	Am. Foundrymen's Assn.	Standard Foundry Costs
Iron	10	Do.	Do.
Ventilating systems	5	Piez, Chas.	Trans. A. S. M. E., 1916
Wagons, general	5	Philadelphia Controller	Manual of Accounting
Dump and hauling	18¾	Associated General Contractors	Bulletin, February 26, 1921
Warehouses, steel and tile	2	Philadelphia Controller	Manual of Accounting
Water mains, cast iron	2	Bd. Water Com., Springfield, Mass.	Appraisal Report
Welding apparatus:			
Acetylene	10	Am. Foundrymen's Assn.	Standard Foundry Costs
Electric	5	Do.	Do.
Wells:			
Driven or drilled	1⅓–2	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Gas	10	Do.	Do.
Wharves	3	Gillette & Dana	Mech. & Elect. Cost Data
	2	Philadelphia Controller	Manual of Accounting
Wires, telephone (copper)	5	Foster, H. A.	Eng. Valuation of Public Utilities
	5–10	Grunsky, C. E.	Valuation, Deprec. & Rate Base
Wiring:			
Electric	7½	Belt, R. E.	Foundry Cost Accounting
Switchboard	6	Piez, Chas.	Trans. A. S. M. E., 1916
Woodworking machinery	5	Nicholson & Rohrbach	Cost Accounting
Woolen mill machinery	4–6⅔	Szepesi, Eugene	Cost Control for Textile Mills

CHAPTER XXXVII

DEDUCTIONS FOR EXTRAORDINARY OBSOLESCENCE AND AMORTIZATION

During 1922, while there was only one important ruling issued by the Treasury dealing with obsolescence, it has been the subject of intensive study, particularly in the determination of depreciation rates. The period to which it should be allocated is, however, not yet settled, since the Treasury in effect denies the full allowance in some cases.[1]

The Treasury during the year ruled that when claims for amortization had not been filed under the 1918 or 1921 laws, the benefits of such amortization deduction under the 1918 law could be obtained by making claim for refund under section 252. The Treasury also published a list of ratios of estimated post-war cost of replacement to June 30, 1916, prices for use in computing "tentative" allowances. The ratios are so high that, if used, there would in many cases be no allowances.

Obsolescence

LAW. Section 214. **(a) That in computing net income there shall be allowed as deductions: . . . .**

(8) **A reasonable allowance for . . . . obsolescence[2]. . . .**

The Treasury prior to 1918 allowed as deductions realized obsolescence. As such deductions could have been made as losses, whether or not obsolescence as such was specified in the law, the reason for the specific mention of obsolescence in the 1918 law was to permit the accrual of obsolescence "so as to allow for such future (not past) obsolescence as

[1] C. B. I-1, page 161; A. R. R. 963; pages 1078 and 1083-5.

[2] This section deals with individuals. Section 234 (a-7) applies the same language to corporations.

may be expected from experience to result from the normal progress of the art."[3]

Under the most recent rulings so-called "ordinary obsolescence," viz., that obsolescence which is accruing but which cannot be definitely ascertained, is to be included in the annual depreciation allowances rather than in a specific reserve for obsolescence.

In actual practice, it has not been possible, except in rare instances, to convince revenue agents that the depreciation rate should have added to it a percentage to take care of "accruing obsolescence." In most cases this has been true because the manufacturer himself has had a somewhat hazy idea as to how accruing obsolescence could be estimated, and has not had collected all the facts which are obtainable to show that such obsolescence, while not obvious, is nevertheless a very real thing which he is entitled to deduct in computing net income.

Federal income tax laws prior to 1918 contained no reference to obsolescence and amortization but conditions in 1918 required that explicit authority should be given to the Treasury to grant, and to taxpayers to deduct, adequate allowances for losses which might not otherwise be permitted.

The sudden end of the World War in 1918 is responsible for many problems which have not yet been solved. All taxpayers who increased their plant facilities prior to November, 1918, whether or not for strictly war purposes, must make their decision regarding the effect of post-war conditions prior to March 3, 1924.

Facilities of any kind "for the production of articles contributing to the prosecution of the present war" if acquired or constructed after April 6, 1917, are the subject of a special deduction, but taxpayers whose facilities do not come within the technical meaning of section 234 (a-8) nevertheless are entitled [under section 234 (a-7)] to "a reasonable allowance for the exhaustion, wear and tear of property used in the trade

[3] Art. 166.

or business, including a reasonable allowance for obsolescence."

The author believes that sufficient consideration has not been given to the extraordinary cost of facilities acquired after 1915, the extraordinary wear and tear of all facilities during 1917 and 1918, and the extraordinary diminution in value of such facilities as compared with post-war conditions. When claims for amortization allowances under section 234 (a-8) are rejected on technicalities, it may be found that equivalent deductions may be made under section 234 (a-7).

REGULATION. A reasonable allowance for the exhaustion, wear and tear and obsolescence of property used in the trade or business may be deducted from gross income. For convenience such an allowance will usually be referred to as depreciation, excluding from the term any idea of a mere reduction in market value not resulting from exhaustion, wear and tear, or obsolescence. . . . . (Art. 161.)

In viewing obsolescence from the standpoint of a future loss, which nevertheless, because it can be foreseen, should be deducted from income as accruing from year to year, the following is pertinent:

RULING. . . . . Obsolescence, of which the case here presented is typical, is not like depreciation, a matter of decrease in earning power or in absolute efficiency, but only in relative efficiency. It has its origin in the fact that although the original efficiency be maintained, yet, owing to improvements in the art or changed economic conditions, a device or factor in production will eventually have to be discarded. The loss is a future loss, but for equitable reasons the statute permits it to be spread over the period for which it can be foreseen, and allows the portion assignable to the period subsequent to December 31, 1917, to be deducted pro rata over such period.

In the instant case the vessels of the 5,000-ton class will today net *x* cents freight per mile, as when they were first constructed. Their intrinsic value is unimpaired, but, because the newer and larger type will earn from six to eight times as much, it is evident that, when the number of larger vessels becomes sufficient to handle the carrying trade of the Great Lakes, the smaller vessels will become economically impossible of operation and will necessarily be discarded or junked. . . . . (C. B. I-1, page 161; A. R. R. 963.)

Obsolescence as described above has been discussed in the preceding chapter. Obsolescence which may be said to be "realized" is considered in the following pages.

The foregoing regulation accords with proper accounting methods. Depreciation allowances set up by conservative concerns were always supposed to be sufficient to include adequate provision for ordinary obsolescence. It follows that in fact deductions were made for obsolescence. The law now definitely sanctions the deductions which taxpayers have been making and the Treasury has been allowing for some years.

Treasury Procedure as to Obsolescence

Under previous laws the Treasury allowed as deductions reserves for depreciation, but did not allow reserves specifically for obsolescence.

Reserves for obsolescence which appeared on taxpayers' books at the beginning of the taxable year ending in 1918 were not allowable as deductions under earlier income tax laws. In order to avoid great annoyance and possible complications in the future it would be proper in most cases to transfer obsolescence reserves as of January 1, 1918, to surplus account. Commencing with that date, obsolescence reserves should reflect allowances claimed and allowed for income tax purposes.

The contention of the Income Tax Unit that surplus accruing in years prior to 1918 should be reduced by accruing obsolescence in those years, was overruled by the Committee on Appeals and Review.[4]

Duplicate deductions must be avoided.—No well-regulated concern would charge off the same item of plant or equipment more than once, but on this point the law contains a special warning. Care must be taken that any allowances for depreciation or obsolescence or amortization claimed *and allowed* in returns for years prior to the taxable year be not claimed again.[5] This, however, does not apply to amounts claimed in previous years but not allowed.

[4] C. B. I-1, page 161; A. R. R. 963.
[5] Law, section 215 (a-3).

Present Accounting Practice as to Obsolescence[6]

The author believes the position assumed by the Treasury in regard to obsolescence prior to the enactment of the 1918 law was essentially sound. He is not prepared to support the contention of certain accountants that extraordinary obsolescence, like depreciation, is an item of prime cost.

To the extent that an allowance for ordinary obsolescence has been merged with depreciation it is entirely proper to charge the combined allowance to operating expenses. The attempt to anticipate extraordinary obsolescence should be from profits and not from current income.

Uncertainty of obsolescence.—Ordinary depreciation is certain and cannot be avoided any more than death or taxes. It accrues from day to day. One can see it. Obsolescence when applied to the future (there is no difference of opinion as to the treatment of known obsolescence) is a matter which is more difficult of estimate than depreciation. No one knows when it will come. In some cases, where expected, it has not materialized. In many instances, where not expected, it has come almost at once. It is true that it has occurred in the past on a great scale. Most modern machinery has superseded other machinery which was not worn out, and many a plant, only ten years old, that counted on a twenty-year life for its equipment, for which a depreciation reserve was set up on that basis, has not been able to renew the machinery out of the reserve. It is also true that in view of the rapid strides in all the mechanical sciences, obsolescence is likely to continue indefinitely to be a serious factor in the ultimate cost of producing manufactured goods. Unevenness of practice should be avoided. One man should not be permitted to guess that his machinery, having an estimated effective life, under normal conditions, of ten years, will become obsolete and have to be

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[6] See *Auditing, Theory and Practice,* Vol. I (3rd edition), by R. H. Montgomery, page 329.

replaced within two years. Nor should another, owning the same kind of machinery, be permitted to make his guess four years. The makers of the machinery might testify that it would perform full service for ten years. When claims for obsolescence are reasonable they should and will be allowed. When unreasonable the claimant deserves to be penalized.

Nevertheless, as a result of more intensive study of the subject, it is possible in many cases to arrive at a basis definite enough to warrant making claim therefor in tax returns. For example, a textile concern definitely decided on a certain date to replace certain machinery in two years by more modern machinery, because they are not getting sufficient production from the old machines. The mill is working at capacity and the old machines will be operated almost up to the day they are replaced. Certainly this is a case where the remaining cost of the old machines should be charged off in two years. Another expensive machine was installed largely as an experiment. It is still producing goods, but at too high a cost, and it is practically certain that although production will be carried into next year, that particular process of manufacture will be abandoned, and with it the machine.

Conflict of opinion as to proper practice.—Some accountants flatly contend that it is practicable and desirable to provide for all obsolescence allowances as operating expense. Others, impressed by the fact that obsolescence frequently represents a large item of cost or expense, while not wishing to include it as a direct operating expense, desire to provide for this charge at a point in the accounts before an operating or net profit is shown. Against this it is argued that if obsolescence cannot be reduced to enough of a certainty to make a periodical allowance for it, there is a strong reason for omitting it as an element of prime cost. If it can be estimated closely enough to set aside a definite amount, the author thinks it should be called depreciation rather than obsolescence. If a close estimate cannot be made the allowance should go in

the accounts as an extraordinary expense, rather than as an ordinary operating expense.

Recently it has been contended that when a machine becomes obsolete, the undepreciated cost (constituting the obsolescence deduction, less salvage) should be capitalized, i.e., added to the purchase cost of the new machine.[7] Such a method may be permissible for the purpose of calculation as to whether it is more profitable to install a new machine or continue to operate the old. It should not be confused, however, with the necessity of deducting obsolescence from income.

Extraordinary Obsolescence

The foregoing relates to so-called "ordinary obsolescence." The regulation as to extraordinary obsolescence is as follows:

REGULATION. When, through some change in business conditions, the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in such business, he may claim as a loss for the year in which he takes such action the difference between the cost, or, if acquired prior to March 1, 1913, fair market price or value as of that date of any assets so discarded (less any depreciation sustained and allowable as a deduction in computing net income) and its salvage value remaining. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property has been prematurely discarded, as, for example, where an increase in the cost of or other change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be charged off

[7] *Depreciation, Principles and Application* (1922 edition), by Earl A. Saliers.

on the books and fully explained in returns of income. . . . . (Art. 143.)

The author believes that the foregoing requirement to use as a basis for obsolescence the cost of property acquired since March 1, 1913, is in accord with the law.

When the property has been acquired before March 1, 1913, the deduction for obsolescence, as shown in article 143, is based on its fair market price or value as of that date.

Due to the fact that plant ledgers or other adequate plant records have not been kept, items of plant that are really obsolete may not have been charged off. A careful survey of the plant should be made, and if it can be established that the machines or other equipment actually were obsolete in a year prior to 1922, it is important to establish that fact, since 1921 was the latest year in which profits taxes were in effect. It is to the legitimate advantage of the taxpayer to apply the obsolescence deduction to prior years when the facts warrant such treatment.[8]

Obsolescence accrued prior to taxable year not deductible.—That the Treasury has not been entirely of one mind on the subject of obsolescence is clear from its consideration of bulk freighters on the Great Lakes. Three rulings[9] have been issued, the last in 1922. The Treasury still holds to its position that obsolescence accrued prior to 1918 may not be deducted in a subsequent year. The Committee, however, reversed the Income Tax Unit, holding that surplus need not be reduced by the obsolescence accrued prior to 1918. The Treasury is inconsistent. If surplus is not reduced, then the asset is not reduced in value, and when in a later year it is scrapped, it is difficult to see how the benefit of a deduction for any part of the asset not written down could be denied.

Solicitor's Opinion 114, which is adhered to in A. R. R.

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[8] For discussion of factors of inadequacy and lack of utility, see "Obsolescence," by W. T. Bowker, *American Appraisal News,* October, 1922.

[9] C. B. 2, page 139; A. R. R. 27; C. B. 5, page 148; Sol. Op. 114; and C. B. I-1, page 161; A. R. R. 963.

963, seems to mean that obsolescence that accrued on vessels from 1910 to 1917 inclusive is not a deduction in those years, nor may it be taken in the year when the vessels are disposed of, under the theory that the only allowable deduction in the year of disposal is for the obsolescence which accrues in that year. Also see article 166; page 1025.

The author wholly disagrees with the statement of the Solicitor that Congress intended that the allowance for obsolescence in the 1918 law is a limitation of the deduction. Stated otherwise, the Solicitor contends that deductions for realized obsolescence theretofore allowed by the Treasury under laws which did not mention obsolescence were outlawed by the 1918 law.

Vessels were constructed in 1900 costing $1,000,000 with an estimated life of thirty three years. From 1900 to 1917 depreciation accrued was allowed on a basis of the estimated life of the vessels. In 1921 the vessels were sold for $200,000. In 1918 it was known that the vessels would be obsolete in 1921. The opinion allows obsolescence for the years 1918 to 1921 inclusive on the basis of obsolescence spread over the period 1910 to 1921, which leaves a considerable book value after the sale. The opinion states that the book balance which represents the excess of obsolescence above depreciation for the years 1910 to 1917 may not be written off as obsolescence in 1921; but fails to state whether or not it may be charged off in 1921 as a loss. The reference to each year's accounts being complete in itself indicates that the only loss which arises in the year 1921 is the year's share of the obsolescence.

Under the opinion the net effect of the 1918 law is to decrease the allowable deduction for losses arising from obsolescence. No such meaning can be read into the law nor into the intention of Congress. The allowance for obsolescence was inserted in the 1918 law in conference. As with other sections of the 1918 law, the intention of Congress was to extend and amplify deductions. It is absurd to construe the obsolescence allowance as a foreclosure of a right to claim

obsolescence, yet that is precisely what the Solicitor's opinion holds.

Method of spreading the obsolescence deduction.—In A. R. R. 963, mentioned above, the following formula for computing and spreading the obsolescence deduction in respect of bulk freight vessels on the Great Lakes may be deduced:

Original cost in 1900, say		$100,000
Average life	33 years	
Average term of usefulness	20 years	
Years life remaining if in service more than 20 years	13 years	
At end of 20 years, residual value = 20 per cent of original cost, or		$20,000

After 20th year, value is lost at rate of 1/13 each year. If scrapped before 20th year add 4 per cent of cost to the value at end of 20 years for each year less than 20 years.

If the estimate of the useful life period of the vessel proves to be correct under actual conditions and the vessel is junked at the end of the 20 years, the problem is comparatively simple. The owner will have deducted 60 per cent for physical depreciation. Adding together the 60 per cent for depreciation and the 20 per cent of residual value, 80 per cent of the cost will have been accounted for and there remains 20 per cent to be deducted for obsolescence to be spread evenly over the obsolescence period.

When business is discontinued.—

Ruling. The undepreciated cost of a dam constructed for the purpose of creating an ice lake by a corporation which later discontinued the ice business, the dam showing a substantial salvage value remaining, was charged off the taxpayer's books. The taxpayer contended that this was a "loss of useful value" as contemplated by article 143 of Regulations 45.

The Committee is of the opinion that property so improved can not, as a matter of fact, be valueless, and that there is no evidence establishing a real determinable and determined loss within the meaning of article 143. (C. B. 4, page 165; Digest A. R. R. 498.)

Since the business was discontinued, it is difficult to believe that no obsolescence occurred in an asset that apparently was valueless for any other type of business. The taxpayer, however, must have failed to show that there was an actual loss in value.

Buildings.—

RULING. No amount may be charged off in any year in anticipation of obsolescence of a building which *may* become obsolete five or ten years later. However, a certain amount of obsolescence may be claimed from the time that it becomes certain that at a definite future date the building will be obsolete. . . . . (C. B. 2, page 138; O. D. 381.)

Some of the factors contributing to the obsolescence of buildings are:

1. Changing trade centers.
2. Change of design.
3. Improved methods of planning, construction and operation.
4. Better lighting and ventilating.
5. Erection of adjacent buildings which adversely affect light and ventilation.
6. Appreciation of land values demanding greater interest return.
7. Removal of building restrictions.

An eminent real estate authority has stated:

The change, to a marked extent, from the old, simple types of buildings to the modern complex form, may be said to have taken place about 25 or possibly 30 years ago and it was probably not for another 10 years that all interested in real estate, in mortgages and in construction, realized fully that a new problem, that of the loss of value in great buildings through changing hotel and trade centers, through wear and tear, through change of fashion in design, improvements in method of construction and operation, of planning and designing, was a great, a serious problem.[10]

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[10] *Depreciation*, by Frank Lord, Vice-President, Cross and Brown Co., New York City, quoted in *Income Tax Procedure*, 1922, pages 1141-1143.

The specific problems involved in the obsolescence of office and loft buildings, apartment houses, and other fireproof buildings have been engaging the attention of real estate associations recently and the importance of the problems is being fully recognized. So many factors are involved that nearly every case requires special study.[11]

In the largest cities the enactment of "zoning" laws is serving to give relief in those cases where in the past a sudden change might be wrought, and it must be considered in any estimate of probable obsolescence.

Fixtures.—In some types of business, such as retail candy stores, restaurants, etc., the volume of business achieved is, to an important extent, dependent upon the character and appearance of the equipment and the attractiveness of the furniture and fixtures with which the visitor finds himself surrounded. The demand of the public for elaborateness and lavish display in this regard is a constant and potent factor; and competition in that direction imposes the necessity of pleasing the public, as otherwise there would be an immediate and pronounced decline in patronage. In respect of fixtures of this nature, the ordinary depreciation rates would not adequately represent the loss of useful value accruing, and a very material allowance should each year be made for obsolescence.

CHANGE UNDER RE-LEASING OR UPON MOVING.—

RULING. A taxpayer in rearranging his business property in accordance with a lease, permanently abandoned certain office furniture and fixtures, only a portion of the cost of which had been deducted as depreciation. The portion of the cost not so deducted, less salvage value of the property, is deductible as a loss of useful value under article 143 of Regulations 45. (C. B. 4, page 164; Digest A. R. R. 469.)

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[11] See *The Effect of Obsolescence on the Useful and Profitable Life of Office Buildings,* by Earle Shultz, Vice-President, National Association of Building Owners and Managers.

Obsolescence of intangible property.[12]—Obsolescence of goodwill and other intangible property is allowed by the Treasury, usually upon the discontinuance of a going business, although discontinuance is not absolutely essential. It is also required in case of goodwill that it be assignable,[13] as distinguished from such goodwill as attaches to individuals conducting a business.

Extraordinary obsolescence due to prohibition.—As stated in the regulation already quoted (article 143),[14] an exception to the rule "requiring a sale or other disposition of property in order to establish a loss" is made "where new legislation directly or indirectly makes the continued profitable use of the property impossible."

A concrete illustration of loss occasioned by new legislation is that caused by state and national prohibition. When the slavery question was a live issue there were many who thought that slave owners, who had vested property interests in slaves, should not be deprived of their property without compensation. Likewise there are many who think that those who had acquired property rights in the liquor business should not be subjected to loss without compensation.

As with the slavery question, public sentiment is opposed to governmental compensation for losses sustained by the liquor interests, but when property losses due to prohibition are established those sustaining the losses are entitled to deductions therefor in their income and excess profits tax returns.[15]

In view of the recent rise in the value of vineyards, the obsolescence claimed by reason of prohibition legislation was premature.

The Committee has ruled in a recent case that the good-

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[12] For obsolescence of patents, see page 1052 *et seq.*

[13] C. B. 2, page 141; O. D. 472. For text, see *Income Tax Procedure,* 1922, page 1144.

[14] See page 1082.

[15] For regulations, rulings and illustrations see *Income Tax Procedure,* 1920, pages 743-749; also *Income Tax Procedure,* 1922, pages 1145-1149.

will of an agent for wine-growers was of a personal nature and for that reason no claim for obsolescence could be made.[16]

Amortization of Plant, etc., Used for War Purposes

The 1921 law re-enacted the provisions of the 1918 law with respect to a deduction for amortization of war facilities, but made two important changes:

1. The time limitation on the deduction is fixed at March 3, 1924.
2. Claim for the deduction of amortization in returns filed *under the 1921 law* must be filed not later than date for filing 1921 return.

Two important developments occurred in 1922 as a result of the issuance of Solicitor's Opinion 138,[17] i.e.:

1. Even though no claim for amortization was made in any return, the benefit of the deduction in returns under the 1918 law may be secured by filing claim for refund under section 252.
2. The time limitation on deductions, i.e., March 3, 1924, is in effect extended (on the authority of section 252) to five years from date return was due, which in the case of returns for 1919 and 1920 would carry the limitation date beyond March 3, 1924.

LAW.[18] . . . . In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the war against the German Government, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of such war, there shall be allowed, for any taxable year ending before March 3, 1924 (if claim therefore was made at the time of filing return for the taxable years 1918, 1919, 1920, or 1921) a reasonable de-

[16] C. B. I-1, page 169; A. R. R. 722. For text, see *Income Tax Procedure,* 1922, page 1147-1149.
[17] C. B. I-1, page 174.
[18] Section 214 (a-9), individuals; section 234 (a-8), corporations.

duction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Act of Congress as a deduction in computing net income. At any time before March 3, 1924, the Commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the income, war-profits, and excess-profits taxes for the year or years affected shall be redetermined; and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252; . . . .

In accordance with a joint resolution of Congress dated March 3, 1921, that date is to be considered as marking the termination of the war between the United States and Germany, and for purposes of the 1918 law is held to be the date from which the three-year period for amortization purposes runs.[19] The limitation may not be operative where no return for amortization was previously filed, if a claim for refund is now made under section 252, for the years 1918, 1919 and 1920.[20]

Deductions may be made in returns up to February 29, 1924.—Since taxable years may not end on any day except the last date of the month,[21] the regulations now in force state the limitation date as February 29, 1924.

Regulation. An allowance for amortization may be deducted only in returns filed for taxable years ending on or before February 29, 1924. . . . . (Art. 181.)

Filing claims for amortization.—As a condition precedent to the deduction of an amortization allowance in returns filed *under the 1921 law,* it is necessary that a claim for amortization should have been filed with the return for any of the years 1918, 1919, 1920 and 1921. Any extension of time

[19] Letter to Prentice-Hall, Inc., dated March 22, 1921, signed by Carl A. Mapes, Solicitor of Internal Revenue.
[20] See page 290 *et seq.*
[21] See page 85.

granted for filing 1921 returns automatically extended the time for filing final claims for amortization.

REGULATION. . . . . Such allowance with respect to any period of time subsequent to December 31, 1920, may be deducted only if a claim for amortization (unmistakably differentiated from all other claims for wear, tear, obsolescence, and loss) was made at the time of filing the return for the taxable year 1918, 1919, 1920 or 1921. . . . . (Art. 181.)

The failure to file a claim with the original return for any of the years 1918, 1919, 1920 and 1921 does not prevent a taxpayer from subsequently filing a claim for refund or credit for the years 1918, 1919 and 1920. It does, however, preclude the deduction of amortization in returns filed under the 1921 Act covering the period January 1, 1921, to February 29, 1924. The phrase "if claim therefor was made at the time of filing return for the taxable year 1918, 1919, 1920 or 1921," was included in the 1921 Act with the obvious design of imposing a time limit within which claims were to be asserted. No such qualification was contained in the 1918 law. A taxpayer is therefore entitled to claim an allowance for amortization for the years 1918, 1919 and 1920, according to Solicitor's Opinion 138, at any time within five years after the respective returns were due to be filed.

RULING. The filing of a claim for an amortization deduction in connection with the *original* return for the year 1918, 1919, 1920, or 1921 is a condition precedent to the right to take such deduction in any return under the Revenue Act of 1921.

Where a taxpayer filed a return under the Revenue Act of 1918 for a fiscal year ended in 1921 and later files a return for the same year under the Revenue Act of 1921, the latter return is the original return for the purpose of filing claim for the deduction.

Even though no claim for the deduction was made in connection with the original return for 1918, 1919, 1920, and 1921, a claim for refund or credit for taxes paid under the Revenue Act of 1918, based upon failure to take such deduction, may be allowed in accordance with the provisions of section 252 of the Revenue Act of 1921. . . . . (C. B. I-1, page 174; Digest Sol. Op. 138.)[22]

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[22] Also I-28-402; I. T. 1389.

Most taxpayers considered that the time limit in the 1918 law—"at any time within three years after the termination of the present war"—fixed a date on or before which their amortization claims must be settled. Diligent taxpayers hurriedly prepared claims, often without valuable supporting data which would have made the claim stronger, and filed them with 1918, 1919 and 1920 returns. It appears from the Treasury's latest ruling that they were ill-advised. If they filed a claim for amortization under the 1918 law, the Commissioner may "redetermine" the deduction before March 3, 1924. If they filed no claim for amortization, then there has been no deduction to "redetermine" and the taxpayer has (under section 252) until five years after the return was due to file claim for refund on account of any amortization deduction allowable.

Ruling. . . . . The provision[23] is designed to cover cases where an amortization deduction based on estimates is, *by after events,* shown to be incorrect. In such circumstances the Commissioner is authorized, on the basis of a redetermination, to collect any amount due or to refund or credit any amount overpaid. The provision prevents any contention that where, on the basis of the then known facts, an amortization deduction is reasonable in amount, the amount so deducted is conclusive and the tax liability could not be redetermined in the light of events occurring after filing the return. The terms used indicate that they can have no application where no amortization deduction was taken, since they presuppose an "incorrect" deduction. Therefore, the rights of a taxpayer who has taken no deduction under the Revenue Act of 1918 on account of amortization of a particular facility are not affected by the provision. . . . (C. B. I-1, page 174, Sol. Op. 138.)

Meaning of "amortization."—To amortize means "to destroy; kill; deaden" (*Standard Dictionary*). Therefore a reasonable deduction for amortization means a deduction sufficient to destroy or kill or deaden the values on the books which represent plant or equipment used for war purposes. If the effective or usable value has disappeared entirely, the book value must be entirely killed (amortized). If the effective or

[23] March 3, 1924, limitation on redetermination.

usable value has only partly disappeared, the book value must be killed (amortized) to an extent which will leave a remaining book value representing only the actual worth of the asset.

The law is not ambiguous, but if it were, the statement of Senator Simmons, made in respect to the similar provision under the 1918 law, would make clear the proper method of determining the amount of amortization which the law allows.[24]

Procedure under the Treasury Regulations

No part of the field of income tax procedure has been so prolific of different sets of regulations as that of amortization. The preliminary regulations were issued soon after the 1918 law was passed, and reflected the wording of the law. The regulations issued April 17, 1919, attempted to narrow the scope of the deduction. The Treasury evidently considered that the first regulations were too liberal, and regretted it. Next came T. D. 3123 (issued January 28, 1921) which recognized that the amortization deductions, instead of being allocated entirely to 1918 and 1919, might be extended to subsequent years. Finally, we have a fourth set of regulations under the 1921 law.[25]

What the taxpayer must show.—The successive steps under the new regulations may be summarized as follows:

(a) Statement of facilities to be amortized must show

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[24] Senator Simmons in discussing this point in the Senate, February 11, 1919, said:

"I can answer the Senator generally by saying that if by reason of the investment of his profits in an extension of his yards he has constructed a plant which was necessary in time of war to meet the demands which were made upon him at that time for production, but which after the termination of the war has depreciated in value because not needed; in that case, under the amortization provision he will be allowed to amortize to the full extent of the depreciation in value. Of course, if there is salvage he would be allowed to amortize only down to the salvage value." (*Congressional Record,* February 11, 1919, page 3132.)

[25] For details of prior regulations and rulings, see *Income Tax Procedure,* 1921, pages 907-922.

that they were constructed, erected, installed or acquired on or after April 6, 1917.

(b) The facilities in (a) were for the "production of articles contributing to prosecution of the war," and in the case of vessels "for the transportation of articles or men contributing to the prosecution of such war."

(c) Classification of the facilities under (a) into those
- (1) Sold or discarded, or which will be sold or discarded before March 3, 1924.
- (2) Retained as part of the taxpayer's going business.

(d) Valuation of property in (c):
- (1) Items in (c-1) are taken at actual sale price, or at estimated fair market value at date property will be sold or discarded.
- (2) Items in (c-2) are taken at estimated "value in use" to taxpayer.

(e) Cost (after deducting depreciation, losses, etc., prior to January 1, 1918) less value in (d) will give total amortization deduction which is spread over the

(f) Amortization period, divided as follows:
- (1) For property in (c-1): "Between January 1, 1918[26] and the date when the property was or will be sold or permanently discarded as a war facility" (article 185).
- (2) For property in (c-2): "Between January 1, 1918[27] and the actual or estimated date of cessation of operation as a war facility" (article 185).

(g) The amortization deduction (e), separately computed as to the two classes of property in (c), is spread over the amortization period (f), having reasonable regard for the

[26] ". . . . or if the property was acquired subsequent to that date, January 1, of the year in which acquired" (article 185).

[27] *Ibid.*

gross and net income of each of the years in the amortization period, and, where separately ascertainable, the income from the facilities upon which amortization is claimed. When there are both classes of property, i.e., (c-1) and (c-2), to be considered, the amortization period must be computed separately for each class of property.

Meaning of term "articles contributing to the prosecution of the war."—

REGULATION. . . . . The allowance may be deducted only by taxpayers who after April 6, 1917, have constructed or otherwise acquired plant or other facilities for the actual production of articles contributing to the prosecution of the war. It is not sufficient, to entitle the taxpayer to the allowance, that the nature of his business is such as to contribute to the production of articles. For example, a taxpayer, such as a railroad, whose business activities are confined to transportation (other than water transportation) is not entitled to the allowance. A taxpayer, the nature of whose business is the actual production of articles, however, may claim the allowance with respect to the cost of all buildings, machinery, equipment or other facilities which were constructed for use or which were used in connection with the production of such articles, both in the acquisition and transportation of raw material, the actual process of manufacture or other conversion, and the transportation and marketing of the finished product. . . . . (Art. 183.)

The second sentence of the regulation is restrictive to a degree not justified.

A railroad was denied amortization.[28] A vein of coal was held not to be amortizable.[29] Sugar machinery was held to be amortizable.[30]

The only statement of importance in L. O. 1074, denying amortization to a railroad, is that the facilities of a railroad cannot be said to have been acquired "for the *production of articles* contributing to the prosecution of the war." The opinion holds that it was the specific reference to vessels which had more bearing than any other factor in the case. In an-

[28] C. B. 5, page 159; L. O. 1074.
[29] I-40-536; I. T. 1460.
[30] C. B. 1, page 221; O. D. 259.

other case it probably will be found that the words "contributing to" will be the controlling factor.[31]

When amortization is permitted it must relate to plant or equipment acquired "for the production of articles contributing to the prosecution of the war." The words "contributing to" are almost the broadest and most elastic which could be used. If a mining company, after April 6, 1917, erected a new smelter which was used to smelt copper ore, which in turn went to a refinery, then to brass works, then to an automobile company for use on a truck, which was used to transport goods on the highways to relieve the freight congestion, the smelter undoubtedly contributed to the prosecution of the war. The evidence here is that through the War Industries Board copper was supposed to be allotted only to those who were engaged in essential industries.

Any industry which was regulated by the War Industries Board can secure evidence as to the degree of its contribution. J. Leonard Replogle, chief of the steel section of the Board, said that steel for corset stays and poker chips was unessential. That would be evidence competent to eliminate the manufacturers of corsets and poker chips from the benefits of the amortization privilege. Between manufacturers of these luxuries or so-called non-essentials and the manufacturers of rifles there is too broad a range to permit one to lay down a definite rule.

The War Industries Board issued priority certificates and clearance privileges to those who were deemed to be contributing to the prosecution of the war. In some cases if a small surplus of raw materials existed it was allotted to uses which were not deemed to be essential. Fuel and transportation were denied to those whose products were deemed to be of less importance than others. At no time during the war, however, was any authoritative list prepared which furnished complete

[31] The *Standard Dictionary* defines "article" as a particular object or substance; as, an *article* of food. See also extract from *Conference Report* (Representative J. W. Fordney), November 19, 1921, page 25, explaining the amendment of the amortization provision, section 214 (a-9).

information. About the time of the signing of the Armistice certain lists had been prepared, and others were in process of preparation, defining less essential products.

Each taxpayer is entitled to prepare his case and make claim based on the conditions which actually confronted him at and after April 6, 1917.

It is not necessary that taxpayers should have had government contracts in order to justify claims for amortization. Revenue agents and taxpayers alike have in many cases labored under this fallacy.

Building permits were difficult to obtain and the purchase of equipment was even more difficult. The mere fact that a permit was secured or machinery was purchased and installed after, say, January, 1918, is, in the opinion of the author, *prima facie* evidence that the new plant or additions to existing plant or the new equipment or additions to existing equipment were for the purpose of contributing to the prosecution of the war. Prior to that time restrictions were not in force, except to a limited extent, but the demand for war materials was so great and the sentiment against non-essential work so strong that at almost any time after April 6, 1917, the mere fact that buildings were erected and machinery was purchased is strong evidence that they were intended to contribute to the prosecution of the war. The cost of buildings and equipment was so much above pre-war prices that those who were not engaged in war work were deterred from making commitments.

Ruling. Machinery, equipment, or other facilities erected or acquired on or after April 6, 1917, for the production or manufacture of sugar is considered as contributing to the prosecution of the war, and the cost may be amortized in accordance with the provisions of section 234 (a) (8) of the Revenue Act of 1918. (C. B. 1, page 221; O. D. 259.)

Property which may be amortized.—The general provision is similar to that in Regulations 45.

Regulation. The taxpayer may deduct from gross income a reasonable allowance for amortization of the cost of buildings, machinery, equipment, or other facilities, constructed, erected, in-

stalled, or acquired on or after April 6, 1917, for the production of articles contributing to the prosecution of the war against the German Government, and of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of such war. . . . . (Art. 183.)

It may be assumed that the words "German Government" are fully inclusive of the Austrian Government.

REGULATION. . . . . In the case of facilities the construction, erection, installation or acquisition of which was commenced before April 6, 1917, and completed subsequent to that date amortization will be allowed with respect only to that part of the cost incurred on or after April 6, 1917, and which was (or should have been) properly entered on the books of the taxpayer on or after that date. (Art 183.)

In the regulations provision is not made for war facilities acquired prior to April 6, 1917, (the date of our entrance into the war). Facilities acquired before that date for war work for the other Allied nations would seem therefore to be excluded, even though subsequently used to produce articles for the United States government. For this reason it is important to ascertain the date of acquisition of each item in the claim.

No limit is set on the date *after* April 6, 1917, that war facilities might be acquired. For example, if contracts for buildings were entered into prior to the Armistice and the work was not completed until 1919, amortization could still be claimed on such building.

LEASED PROPERTY.—

RULING. War facilities erected by a lessee on leased property, title to which vested in the lessor immediately on completion, are subject to an amortization allowance by the lessee. (I-31-437; Digest A. R. R. 1009.)

The reason underlying the foregoing ruling is that ownership of war facilities is not prerequisite to an amortization allowance. The governing necessity is that the cost of the facilities must have been borne by the taxpayer, which in this case is the lessee, who satisfies the requirement.

Treatment of allowances made to taxpayers by a contracting department of the government.—

Regulation. . . . . All allowances made to a taxpayer by a contracting department of the Government, or by any other contractor, for amortization specifically as such, shall be treated as a reduction of the cost of the taxpayer's plant investment. Further amortization is allowable only in respect of such reduced cost. Where no such allowance has been made the amount of amortization to be allowed as a deduction from gross income, for the purpose of the tax, shall be computed in accordance with the provisions of articles 181 to 189, pursuant to which the deduction must be made, and not upon the basis of any amount contractually or otherwise determined. (Art. 181.)

The foregoing regulation is in accord with the law and with good accounting practice.

The regulation recognizes amortization which has been allowed by some other department of the government. The refusal of the Treasury prior to 1922 to accept settlements made by the War and Navy Departments occasioned much difficulty in the preparation of claims. Taxpayers are justified in placing great weight on appraisals and allowances officially determined by the government. It will be found that the courts will place equal weight on such settlements. Nevertheless it is within the power of the Commissioner to require that all claims for amortization be submitted in a form acceptable to the Treasury, provided always that the requirements are reasonable. If not reasonable, taxpayers should submit claims conforming to the law itself. Obviously the regulations should be complied with to every possible extent.

Depreciation allowances.—

Regulation. The allowance for amortization shall be inclusive of all depreciation during the amortization period on property subject to amortization. . . . Depreciation will be allowed, beginning at the close of the amortization period, upon property the cost of which has been partly amortized, but shall be limited to the value of such property after the amortization allowance has been deducted. Property which has been amortized to its scrap value shall not further be subject to depreciation. (Art. 182.)

The old regulation (before amendment in 1921) contained the clause, "Depreciation for any taxable period after December 31, 1917 should, therefore, not be claimed with respect to property as to which an allowance for amortization is claimed." Taxpayers were led to believe that depreciation could not be claimed on the unamortized balance of property with respect to which amortization had been claimed in 1918 and 1919 returns. The new regulation omits this clause and there is now no doubt that depreciation on any unamortized balance of cost of property can be claimed the same as on any other depreciable property. This unamortized balance will be the "value in use" as finally determined.[32]

Computation of loss.—

REGULATION. The total amount of the amortization allowance is the difference between the original cost of the property if constructed, erected, installed, or acquired on or after April 6, 1917; or if acquired partly before and partly after April 6, 1917, then that part of the cost incurred on or after April 6, 1917, and properly entered on the books of the taxpayer on or after that date, less any amounts deducted for depreciation, losses, etc., prior to January 1, 1918, and the value of the property on either of the bases indicated below:

(1) In the case of property which has been sold or permanently discarded, or which will be sold or permanently discarded before March 3, 1924, the value shall be the actual sale price or estimated fair market value as of the date when the property was or will be permanently discarded plus a reasonable allowance for depreciation in case the property is used in the taxpayer's business after the close of the amortization period. Such fair market value shall be established by investigation of engineers of the Bureau of Internal Revenue, if such investigation is deemed advisable.

(2) In the case of property not included in (1) above, the value shall be the estimated value to the taxpayer in terms of its actual use or employment in his going business, such value to be not less than the sale or salvage value of the property and not greater than the estimated cost of replacement under normal postwar conditions less depreciation and depletion. Upon the basis of the costs prevailing at the latest prewar date at which a reasonably normal market existed, the Commissioner shall in respect of basic material and labor costs determine and publish ratios of estimated postwar costs of

[32] See page 1106.

replacement, and a taxpayer shall use such ratios in computing a claim for a tentative allowance for amortization. Such tentative allowance may be redetermined on or before March 3, 1924, at the request of the taxpayer or by the Commissioner.

Special record of all property falling in (1) above, must be preserved by the taxpayer, and the Commissioner must be notified with the next tax return (*a*) if, after having been in good faith permanently discarded or dismantled, property shall in any case be restored to use because of conditions not foreseen or anticipated at the time it was discarded; or (*b*) of the selling price, if sold. (Art. 184.)

Property described in clause (1) of article 184 is that sold or discarded, or which will be sold or discarded before March 3, 1924.

Property described in clause (2) of the same article is that retained as part of the taxpayers' going business.[33]

In the case of items in clause (1) it will usually be necessary to work back from the value at date of discard. Assume that a war facility which ceased operation as such on December 31, 1918, was operated on peace-time work in 1919 and discarded December 31, 1920. To the value as at December 31, 1920, should be added back the depreciation charged on such facility in 1919 and 1920. The difference between this sum and depreciated cost January 1, 1918, is the amount of amortization allowance to be charged against the year 1918.

"Value in use."—Some of the most difficult problems in handling amortization claims arise in the determination of "value in use"—i.e., what, in the language of article 184, clause (2), is the "estimated value to the taxpayer in terms of its actual use or employment in his going business." One solution of the problem, or avoidance of the problem, was for the taxpayer to have sold, lock, stock and barrel, all of

[33] [Former Procedure] T. D. 3123 (Art. 184) eliminated the restrictive clause limiting the deduction for facilities which it was known would be discarded in the future, to those to be discarded "before the last installment payment of the tax" covered by the 1919 returns. It also eliminated the sentence reading: "for the purpose of returns made in 1919, the preliminary estimate of the amount of such amortization shall not, in any case, have exceeded 25% of the cost of the property." The author contended that such a provision was not legal. See *Income Tax Procedure,* 1921, pages 920-922.

the facilities acquired for war production. This was done in many cases by the du Pont companies. But the majority of manufacturers retained their war facilities and attempted to adapt them to peace time uses. Such attempts have not on the whole been conspicuously successful. In some cases new lines of manufacturing were undertaken, in which it was deemed possible to use the war facilities, which lines were subsequently abandoned and the equipment had again to be "adapted" to some other use.

It should be noted that article 184 says that the value in use shall be "not *greater* than the estimated cost of replacement under normal post-war conditions." This is a limitation on the revenue agents, not on the taxpayer. The taxpayer is almost always concerned with proving the cost of replacement of a particular machine but this is really irrelevant in most cases in establishing the value-in-use. For example, a heavy drill with a special head cost $250. With a new head adapted to simple work it is today doing the work of a drill that could be bought for $35. Yet the replacement cost of the heavy drill is not less than $150. The value in use to the taxpayer is obviously not more than $35.

Again, building costs have not come down materially since the war. In recent months they have gone up. Therefore, on a replacement cost basis no deduction at all for amortization would appear. Superficially, it might almost seem that the taxpayer was better off—he owned a building which today could be replaced only at greater cost than he paid for it in the war years. But the chances are 10 to 1 that that particular building is not suited to his peace time production—the ceilings may be too low or too high, the fire hazard may have been increased, or the building may cut off light and ventilation of other buildings, all of which considerations were not a factor in the heat of wartime construction. They do, however, affect adversely the value in use under post-war conditions.

When the engineers from the Treasury see machinery

such as that described above 100 per cent in use—or the buildings referred to used perhaps for storage purposes—they have been inclined to disallow any claim for amortization. Usually this has been true only in those cases where the claim did not point out specifically all the special circumstances which materially differentiate value-in-use from replacement cost. It is incumbent on taxpayers, therefore, to present all facts that tend to show that what may appear to be a valuable asset is of much less value, viewed from the standpoint of use in a going business under competitive conditions.

As a matter of fact, some concerns as a result of engaging whole-heartedly in war work, now find themselves with a lot of ill-adapted equipment, and their customers captured by competitors who looked after their commercial needs during the war period. They have not the resources to scrap all the war facilities and buy an entirely new equipment, but must proceed with what they have, even though it is not what they would choose for post-war production.

Generalizations carry little weight with the Treasury. It is necessary, therefore, to be specific in respect of each item in the claim. It is clear, however, that an attempt to use for peace purposes a plant which had been constructed during the war period, cannot in itself be construed to limit amortization claims, particularly when the attempt is unsuccessful.

Estimated post-war costs of replacement.—

Ruling. . . . . All ratios are expressed in percentages based on prices as of June 30, 1916.

A. Ratios for computing estimated postwar cost of replacement of buildings, vessels, cars, tanks, blast furnaces, open-hearth furnaces, annealing furnaces, electric furnaces, coke ovens, and construction of all kinds:

	Per cent.
1. Lumber—	
(a) Hard	240
(b) Soft	175
2. Structural steel	60
3. Building materials, other than lumber and structural steel	225
4. Steel (other than structural steel) and steel products	90
5. Building equipment	150
6. Labor (all classes)	160

B. Ratios for computing estimated postwar costs or replacement of machinery and equipment:

7. Electrical machinery and equipment	130
8. Engines, turbines, compressors, and similar facilities	175
9. Pumps	135
10. Boilers	160
11. Transmission equipment—	
(*a*) Shafting, pulley, hangers, etc	135
(*b*) Belting	100
12. Machine tools and small tools (machine tools are considered as that class of metal-working machinery which can be used on *both* cast iron and steel)	130
13. Wood-working machinery	155
14. Textile machinery	155
15. All other machinery (including cranes)—	
(*a*) Machinery, the cost of which did not exceed 10 cents per pound as of June 30, 1916	120
(*b*) Machinery, the cost of which did exceed 10 cents per pound as of June 30, 1916	130
16. Office furniture and equipment	125

(C. B. I-1, page 178; T. D. 3333.)

It is stated by the Commissioner that the values obtained by the use of these ratios are tentative; they are subject to redetermination at any time before March 3, 1924. Under this ruling all taxpayers are required to submit their claims on the basis of these ratios. In cases where the stated ratios are considered inapplicable, a statement is to be furnished with the claim setting forth the reason why a different basis should be used.

June 30, 1916, has been decided upon by the Commissioner as "the latest prewar date at which a reasonably normal market existed." Yet in designating a period of normal profits for the purpose of levying a tax on excess profits, Congress used an average of the years 1911, 1912 and 1913 and termed those years "the prewar period." This in itself is indicative of the fact that the framers of the 1917 law did not believe that profits were normal during the years 1914, 1915 and 1916. Their reason is not far to seek. During those years, American manufacturers were supplying large quantities of war supplies to European countries, thus causing an expansion of business which resulted in a gradual inflation of prices—and its natural corollary, abnormal profits.

It is a fair assumption that if the basis of the ratios used

by the Commissioner were an average of the costs existing during the years 1911, 1912 and 1913, instead of the costs at June 30, 1916, still higher percentages than those promulgated by the Commissioner would have to be used to arrive at the same "post-war values." It is hardly credible that under stable post-war conditions costs will be so much in excess of corresponding values during the years 1911, 1912 and 1913, as a revision of the Commissioner's ratios to base them on those years would indicate.

On account of the taxpayer's experience and knowledge of the conditions related to his own particular business, it is probable that he may be able to judge the future tendency of the market as affecting articles similar to those on which he is claiming amortization. In such cases an estimate of post-war values should be made, independently of the published ratios, and full details supporting the prices adopted should be submitted with the claim. This refers only to claims which may yet be filed under the Revenue Act of 1918.

Before the period of redetermination expires, both the taxpayer and the Commissioner will in all cases be in a better position to gauge the level of stable post-war prices.

The following case illustrates the method of applying these ratios:

Machine tools costing $20,000, and having a ten-year life, were acquired on July 1, 1917, for the production of articles contributing to the prosecution of the war. Their use as a war facility ceased on December 31, 1918.

Computation of amortization allowance:

Cost		$20,000
Deduct depreciation for six months ended December 31, 1917, at 10 per cent per annum		1,000
Depreciated cost at January 1, 1918		$19,000
Cost of similar equipment at June 30, 1916	$15,000	
Post-war replacement cost thereof, using ratio of 130 per cent	$19,500	
Deduct depreciation for eighteen months ended December 31, 1918, at 10 per cent per annum	2,925	
Residual value in use at December 31, 1918		16,575
Amortization allowance deductible in the year 1918		$2,425

Future depreciation of the equipment is based upon the residual value of $16,575 and its remaining life of 8½ years.

It will be noted from the foregoing illustration that if the value at June 30, 1916, was much in excess of $15,000 no amortization could be claimed, as the residual value would be higher than the depreciated cost at December 31, 1918. For instance, if the value at June 30, 1916, was $16,000, the post-war replacement cost would be $20,800, or $800 higher than the actual cost. The taxpayer would then merely deduct $2,000, representing depreciation for the year 1918. As a matter of fact machine tools on June 30, 1916, were much higher in price than during the latter part of 1915. The pre-war price of tools costing $20,000 in 1917 was nearer $10,000 than $15,000.

Period to which loss is apportioned.—

REGULATION. The amortization allowance shall be apportioned (a) in cases where the property was employed in the production of articles contributing to the prosecution of the war, over the respective accounting periods of the taxpayer, having reasonable regard to his gross and net income, and where separately ascertainable the income from the facilities upon which amortization is claimed, between January 1, 1918 (or if the property was acquired subsequent to that date, January 1 of the year in which acquired), and the actual or estimated date of cessation of operations as a war facility, and (b) in cases where the property was not completed in time for use in the production of articles contributing to the prosecution of the war, on the basis of the expenditures made on account of which amortization is allowed. . . . . (Art. 185.)[34]

If all the net income from a particular facility was received in 1919, although it was also in operation during 1918, the Treasury would probably attempt to apportion all of the amortization in respect to that facility to the year 1919 with its lower tax rates. In many cases this might not be equitable.

BASIS OF APPORTIONMENT—FISCAL YEAR.—

REGULATION. . . . . All taxpayers claiming an allowance for amortization shall compute the amount of their claims applicable to

[34] [Former Procedure] The apportionment was formerly made on the basis of net income. See Reg. 45, Art. 185.

each accounting period between January 1, 1918, to the date specified above. Taxpayers reporting on the fiscal year basis shall (*a*) in all computations based upon 1918 rates for years ending in 1918 and 1919 use the amount of such allowance apportioned to the calendar year 1918; (*b*) in all computations based upon 1919 rates for a year beginning in 1918 and ending in 1919, use the amount of such allowance apportioned to the calendar year 1919; (*c*) in all computations for a year beginning in 1919 and ending in 1920, use the number of twelfths of the allowance apportioned to each calendar year falling within such fiscal year that there are months of such calendar year falling within such fiscal year; (*d*) in all computations based upon 1920 rates for a year beginning in 1920 and ending in 1921, use the amount of such allowance apportioned to the calendar year 1920; (*e*) in all computations based upon 1921 rates for years ending in 1921 or 1922, use the amount of such allowance apportioned to the calendar year 1921; (*f*) in all computations based upon 1922 rates for a year beginning in 1921 and ending in 1922, use the amount of such allowance apportioned to the calendar year 1922; (*g*) and in all computations for subsequent fiscal years use the number of twelfths of the allowance apportioned to each calendar year falling within such fiscal year that there are months in such calendar year falling within such fiscal year. (Art. 185.)

The law imposes no limitation on the amount of amortization to be deducted in any one year, nor does it state that the entire amortization must be claimed as a deduction against one year's income. The intent of the law would seem to be to permit taxpayers who erected plants for war purposes to write off, as quickly as possible, the excess cost of such plants over normal or pre-war cost and to apply such write-off in reduction of income reported for taxation. Until such excess cost has been written off there is no income which should be taxed. Until the excess has been written off such taxpayers are not on an equal basis with other taxpayers who constructed their plants before the war and made no new capital expenditures to assist in the prosecution of the war. Furthermore, the deduction for amortization is not actually being fully allowed if in part or in whole it is included in a tax return to an amount in excess of the net income determined prior to the application of the amortization deduction.

Assuming that the amortization allowance exceeds the net

income of 1918, it would seem logical to apply the net income of each year from 1918 onward against the amortization allowance and to tax income only after the amortization has been fully applied against income.

It would of course defeat the purpose of the relief intended if a taxpayer were required to take the amortization deduction in a period when he had no net income. Such was not the intention of the law. It was assumed that war facilities produced an income while being used and that if their profitable use was diminished by the end of the war there should be an adjustment of the apparent profits equal to the loss sustained.

If a taxpayer required several months in 1919 to secure a market or use for war facilities and during those months the facilities were not producing a profit, the entire loss should be charged to 1918.

The method laid down in article 185 may work equitably in some cases. If the application of the method to a particular case does not yield to the taxpayer a reasonable deduction for amortization, some other method should be used.

Taxpayers should prepare an estimate of the loss sustained and then apply the loss to the period affected. The accounts should be adjusted accordingly and if the result is not the same as would be produced by the conflicting methods in the regulations the taxpayer will have to look to the courts for a correct interpretation of the law.

Taxpayer's books and statements.—

Regulation. Claims for amortization must be unmistakably differentiated in the return from all other claims for wear, tear, obsolescence, and loss. If Government or other contracts taken by the taxpayer contained recognition of amortization as an element in the cost of production, copies of such contracts shall be filed with the taxpayer's return, together with a statement and description of any sums received on account of amortization and the basis upon which they were determined. In any case in which an allowance has been made for amortization of cost the taxpayer will not be allowed to restore to his invested capital for the purpose of the war-profits and

excess-profits tax any portion of the amount covered by such allowance. (Art. 186.)

The statement in Regulations 45 that, "No such claim will be allowed unless it is reflected in any accounts submitted by the taxpayer to stockholders and in any credit statements by the taxpayer to banks, and is given full effect on his financial books of account," has been eliminated.

It is a reasonable requirement that a taxpayer's books should reflect all transactions. When claim for amortization is made, the loss should (so far as feasible in advance of final determination of the allowances) be charged against the period to which it belongs.

In submitting final claims which may modify prior claims and an early adjustment of the whole matter is contemplated, it may be desirable to await final adjudication before making further adjustments in the books.

Estimates to be adjusted before March 3, 1924.[35]—

REGULATION. A redetermination of the deduction allowed on account of amortization may, or at the request of the taxpayer shall, be made by the Commissioner at any time before March 3, 1924, and if as a result of an appraisal or from other evidence it is found that the deduction originally allowed was incorrect, the amount of tax due for each taxable year during the amortization period will be adjusted by additional assessment or by refund. (Art. 187.)

It should always be kept in mind that the original claim was based on an estimate, except in the case of sale or some other definite means of determination.

Taxpayers may present to the Commissioner their claim for a redetermination at any time prior to March 3, 1924.[36] Until the Commissioner announces his final determination, taxpayers need not consider that the matter is ready for final adjudication. When such final determination is announced, taxpayers have a statutory right of appeal, at which time, and

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[35] But see section 250 (d); also see pages 1090-1092.
[36] See also C. B. 1, page 140; A. R. M. 10.

not before, the rights of taxpayers to revise their claims will end.

When it is found that the estimate was too large or too small the facts should be reported without delay and the taxes of the prior years should be redetermined.

When an original estimate of loss proves to be excessive, because facilities believed to be of lessened value at the end of the taxable year 1919 have subsequently increased in value, amended returns should of course be made.

But if on subsequent sale facilities should be sold for more than book value, exclusive of amortization, the profit realized should be reported as of the period of sale and only the amount of amortization restored to the original period. This accords with the usual rule that appreciation in value should not be reported until realized.

Regulation. In the case of the bona fide sale of amortized property before March 3, 1924, the sale price thereof will be considered as reflecting the correctness or incorrectness of the amortization allowance made, due allowance being made for depreciation sustained since the close of the amortization period. (Art. 188.)

Detailed information to support claim must be filed.—

Regulation. The taxpayer's claim for amortization must be complete and comprehensive in all respects. The Commissioner will not entertain claims which do not clearly set forth full data with respect to the property which it is desired to amortize.

To assist the taxpayer in compiling this information the Commissioner has prepared Guide Form 1007-M, which explains in detail the manner in which claims for amortization should be presented. A copy of this guide form will be furnished to the taxpayer upon application to the Commissioner. (Art. 189.)

The Treasury requires comprehensive data as to original cost, depreciation sustained, when acquired or constructed, proof as to "value in use," and the various computations necessary to allocate the deduction to the proper years. A copy of the Guide Form 1007-M referred to above will be found in Appendix B of *Income Tax Procedure,* 1922.

CHAPTER XXXVIII

DEDUCTIONS FOR DEPLETION

The 1921 law re-enacted the provisions of the 1918 law regarding depletion. "A reasonable allowance for depletion" is permitted in the case of those industries with wasting assets because of the exhaustion of the minerals, oil, timber, etc. The allowance represents a return of capital. While the provision permitting a "discovery" value as a basis for depletion (in case of properties "discovered" on or after March 1, 1913) is retained in the present law, a limitation on securing the benefit of the full amount of such depletion is now imposed. The effects of this limitation are (a) to prevent carrying forward into a succeeding year (as a net loss—see section 204) any excess of depletion based on "discovery" value over net income from the property, and (b) to deny the offsetting of such excess depletion against income from other sources, such as income from investments or from the operation of another property. In the case of oil wells, the "discovery" feature is doubtless invoked in respect of many properties acquired since March 1, 1913. As in so many of the other so-called "cushion" provisions of the income tax laws, Congress having first given the taxpayer relief in one provision, proceeds to take away, in another provision, much of the benefit. On the other hand, it may be assumed that "discovery" values may well be so high that the depletion charge, in a year of depression, may easily exceed all income from the property. In any event the taxpayer will receive the benefit of "discovery" depletion up to the amount of the income from the property, should such depletion be greater than the income from the property.

Law. Section 214. (a-10) [Individuals] Section 234. (a-9) [Corporations.] That in computing net income there shall be allowed as deductions: . . . .

In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter: *And provided further,* That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee; . . . .[1]

The theory of depletion is comparatively simple, viz., pro-

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[1] [Former Procedure] Under the 1909 law no deduction could be made for depletion. *Von Baumbach, Collector, v. Sargent Land Co.,* 242 U. S. 503, 37 Sup. Ct. 201, 61 L. Ed. 460. For a full discussion and criticism of this decision see *Income Tax Procedure,* 1918, pages 406-408.

The 1913 law limited the deduction to "5 per centum of the gross value at the mine of the output for the year for which the computation is made" [section II G (b)]. The Supreme Court of the United States held that this 5 per cent limitation was constitutional. *Stanton v. Baltic Mining Company,* 240 U. S. 103, 36 Sup. Ct. 278, 60 L. Ed. 546. For a full discussion of the procedure under this limitation of the 1913 law, see *Income Tax Procedure,* 1918, pages 402-406.

The 1916 law, unchanged in 1917, [section 5, Eighth (a), individuals, and section 12 (a), Second, corporations] was in part as follows:

"(a) In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) in the case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation are made."

The 1921 law is the same as the 1918 law, with the exception of the limitation on "discovery" depletion.

vision must be made for the return of capital invested in natural resources which are being exhausted. The capital to be returned is original cost, or value as at March 1, 1913, if acquired prior thereto, or a "discovery" value in certain cases of property acquired after March 1, 1913. This involves a periodical charge against the gross earnings realized from the product, of such amounts as will in the aggregate equal the original outlay by the time the property shall have been exhausted. It is in the application of the theory, or rather in securing the requisite data, that the practical difficulties are encountered. Two fundamental facts must be established, as follows:

(a) Value of the property at March 1, 1913, if acquired prior thereto, or within thirty days after "discovery" if acquired after March 1, 1913;[2] and
(b) The number of units of principal product in the property at valuation date.

The depletion unit [a ÷ b] multiplied by the number of units produced during the year, gives the depletion deduction for the taxable year.

As soon as the reserve for depletion equals the capital investment, no further charges can be made, no matter how much more product may be recovered. The excess is all income and must be so returned.

The language of the 1921 law is broad enough to permit the full deduction demanded by the theory of depletion.

The latest regulations[3] of the Treasury reflect the general principles to be observed in arriving at proper valuation, the determination of the proper number of mineral units embraced therein, and proper depletion charges.

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[2] If the property was acquired after March 1, 1913, and no "discovery" value is claimed, cost is used as factor (a). If the value at March 1, 1913, is less than cost, after making allowance for any mineral removed to that date, it would seem that the taxpayer is entitled to get back his cost. See *Distributions from the Depletion Reserve*, by Paul Armitage. (Address before American Mining Congress, Cleveland, Ohio, October, 1922, pages 2-3.)

[3] Reg. 62, promulgated February 15, 1922.

The major problem, however, is to assemble the tremendous amount of data required to support the valuations to the satisfaction of the Treasury. Fortunately, many mining companies have excellent records from which the data regarding assay values, recovery of metal contents, costs, proper rates of discounts in the case of mines, and the other factors can be compiled and stated.

In arriving at the depletion rate, consideration must also be given to the effect that the value established for depletion may have on the distributions to stockholders in the form of dividends free from tax.[4]

Practically, it will be found in every case that where an attempt is being made to establish the proper depletion rate, a series of problems, as indicated above, follows in the train of what theoretically is quite a simple matter. When a company owns a series of mining claims it is often a question as to how much should be taken in, in those cases where the ore is not blocked out, and how much, if any, in the future may be brought in under the discovery provision.

Depletion, at the option of the taxpayer, is made to embrace recovery of capital expenditures other than for ore, and this gives rise to questions of what are really capital items in a business of the character peculiar to wasting assets, and what is properly chargeable to expense.

General procedure in case of depletion.—

Basis of depletion allowance.—The first step in determining the depletion deduction is to establish a proper valuation of the property at March 1, 1913,[5] if acquired prior thereto, or at the "discovery" date, if acquired after March 1, 1913, and a "discovery" is claimed, for it is on these respective values that depletion is based, except that if a property was

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[4] See page 1118 *et seq.*. See also Chapter XXII, page 592 *et seq.*

[5] See page 1115 with respect to case where cost less depletion to March 1, 1913, exceeds valuation at that date .

acquired after March 1, 1913, and a "discovery" is not claimed, the depletion deduction is based on cost.[6]

If the property was acquired prior to March 1, 1913, depletion for the period prior to March 1, 1913, would be computed on the basis of the value of the property at the date acquired,[7] plus allowable capital additions. Beginning with March 1, 1913, depletion would be computed on the value at that date, which usually includes a large amount of appreciation in value. For instance, an individual may have purchased coal lands in 1908 at $400 per acre and thereafter may have charged off periodically against product such an allowance as would reasonably write off the cost before the tract was exhausted. If the value of the unmined coal appreciated, and it could be demonstrated that on March 1, 1913, the fair value was $800 per acre, subsequent to that date the charge for depletion should be doubled.

When such a condition exists, the proper procedure is to debit the property account and credit an account called "Surplus arising from reappraisement of property." The property account, as so valued, will then be the basis of depletion charges. An adjustment should be made to have the account properly reflect the necessary charges to the beginning of the taxable year, and thereafter the annual charges should be accurately calculated.[8]

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[6] See page 1113, footnote 2.

[7] [Former Procedure] For purposes of invested capital, it is also necessary sometimes to obtain a valuation at the date the property was paid in, as the actual value of the property may have been either more or less than the par value of stock issued therefor.

[8] [Former Procedure] If such an account is created it will be desirable to transfer therefrom, once a year, to the regular surplus account, an amount representing the difference between the aggregate depletion actually charged and the amount which would have been charged on the basis used before revaluation. The chief reason for making such transfer is that the item "invested capital" as defined by the excess profits tax law does not recognize appreciation arising out of revaluations unless a sale takes place, but cash realizations of any part of the profit on assets reappraised are additions to invested capital, commencing with the dates of realization.

The Treasury (in C. B. 5, page 26; L. O. 1073) held that appreciation accrued prior to March 1, 1913, and realized subsequently represents "profits earned during the year," and therefore cannot be included as invested capital in the year in which realized. The theory that such realized appreciation

For a method of separating ledger accounts so that surplus accrued before and after March 1, 1913, will be properly segregated, see page 575.

REGULATION. Sections 214 (a) (10) and 234 (a) (9) provide that taxpayers shall be allowed as a deduction in computing net income in the case of natural deposits a reasonable allowance for depletion of mineral and for depreciation of improvements. These paragraphs of the statute are not materially different from the corresponding paragraphs of the Revenue Act of 1918. These provisions of the statute . . . . do not apply to or affect the regulations covering invested capital, losses, accounting methods, etc.

The essence of these provisions of the statute is that the owner of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depletion and depreciation deductions the return of either (*a*) the cost of his property if acquired subsequent to March 1, 1913, or (*b*) the value of his property on the basic date, plus subsequent allowable capital additions . . . ., but not including land values for purposes other than the extraction of minerals. . . . . (Art. 201.)

The following definitions indicate some of the conditions attending a proper valuation, and make the distinction between (1) the "minerals" which, as shown hereinafter, are valued on one basis; (2) the physical equipment which is usually taken at depreciated cost; and (3) the value of the land, which in some cases may be available for agriculture. The value of land for other than mineral purposes is not to be recovered through depletion charges.[9]

Definitions.—

REGULATION. . . . . When used in these articles . . . . covering depletion and depreciation—

BASIC DATE.—

(*a*) The term "basic date" indicates the date of valuation, i. e., March 1, 1913, in the case of property acquired prior thereto; the date of acquisition in the case of property acquired on or after March

is a profit of the current year also would subject to tax any cash dividends paid from such realized appreciation. Section 201 (b) of the 1921 law and article 1542 of Regulations 62 have set aside the aforementioned ruling. See page 712 *et seq.*

[9] See Art. 205, page 1117.

1, 1913; or the date of discovery, or within thirty days thereafter, in the case of discovery.

Fair market value.—

(*b*) The "fair market value" of a property is that amount which would induce a willing seller to sell and a willing buyer to purchase.

Mineral property.—

(*c*) A "mineral property" or "property" is the mineral deposit, the development and plant necessary for its extraction, and so much of the surface as is reasonably expected to be underlaid with the mineral. The value of a mineral property is the combined value of its component parts.

Mineral deposit.—

(*d*) A "mineral deposit" refers to "minerals only," such as the "ores only" in the case of a mine, to the "oil only" in the case of an oil well, and to the "gas only" in the case of a gas well, and to the "oil and gas" in the case of a well producing both oil and gas. The value of a mineral deposit is its cost, or it is the value of the mineral property, less the value of the plant, equipment, and surface of the land for purposes other than mineral production.

Minerals.—

(*e*) "Minerals" include ores of the metals, coal, oil, gas and such nonmetallic substances as abrasives, asbestos, asphaltum, barytes, borax, building stone, cement rock, clay, crushed stone, feldspar, fluorspar, fuller's earth, graphite, gypsum, limestone, magnesite, marl, mica, mineral pigments, peat, potash, precious stones, refractories, rock phosphate, salt, sand and gravel, silica, slate, soapstone, soda, sulphur, and talc.

Operating profit.—

(*f*) "Operating profit" is the net income from mineral production before depletion and depreciation are deducted. It is distinct from net income. . . . . (Art. 201.)

Cost when used as basis must be bona fide.—

Regulation. In any case in which a depletion or depreciation deduction is computed on the basis of the cost or price at which any mine, mineral deposit, mineral right or leasehold was acquired, the owner or lessee will be required to show that the cost or price at which the property was bought was fixed for the purpose of a bona fide purchase and sale, by which the property passed to an owner in

fact as well as in form other than the vendor. No fictitious or inflated cost or price will be permitted to form the basis of any calculation of a depletion or depreciation deduction, and in determining whether or not the price or cost at which any purchase or sale was made represented the actual market value of the property sold, due weight will be given to the relationship or connection existing between the person selling the property and the buyer thereof. (Art. 205.)

Valuation of Mines

Since in most cases the depletion deduction will be based on the value at March 1, 1913, or on the "discovery" value claimed for properties acquired thereafter, a discussion of some of the particular problems involved is pertinent at this point. Comments on the regulations dealing with valuation are made particularly with reference to mines. Special considerations bearing on the valuation of oil and gas wells follow. The regulations dealing with timber are also considered in this chapter.

In the early days of the administration of the 1917 and 1918 laws, when the matter of the depletion allowance first became of such vital importance, the Treasury attempted to place a value on mining properties gauged by the value of shares of capital stock[10] at or about the date as of which the

[10] "But we must remember that mines are not staples like the metals they produce and that market quotations upon them are of a different order from quotations on staples. Thus lead in a warehouse is always marketable. It is as good as any other lead. Its price varies between certain limits, of course, but the market value, whatever it is, is always there. But there is no such certitude or permanence about the stock of the mine. Today it may be in high favor; five years from now it may be worth twice as much, or nothing at all, and the quotations bear no definite relation to the price of metal, but are influenced strongly, often decisively by other factors.

"Again, we can never be certain that the valuation of stocks by market quotation represents the same action in all cases. Many properties are not on the market at all. Of those actually before the public, some may be in high esteem skillfully advertised and distributed among a large number of holders; others may be scarcely noticed, with few holders, few transfers, and the market may be merely nominal. It is conceivable that the highly advertised stock might bring twice the price of the obscure one, even though both have the same actual merit.

"I think these considerations are generally conceded to be convincing reasons for subjecting the valuation of mines to a searching and independent review every time such property becomes the object of any important transaction." (J. R. Finlay, *Cost of Mining,* 1920 edition, page 44.)

valuation for depletion was to be made. These attempts, on the whole, have proved so unsatisfactory that the Treasury, following recognized engineering methods, is applying in many cases a method based on the present value of anticipated earnings, as stated hereinafter. In some instances, however, certain of the Treasury engineers have used stock market quotations as a measure of value, with resulting unit rates of depletion so far below the values ascribed to similar properties as to be at times almost absurd.

A prominent mining engineer told the author recently that the stock of a company in which he was a stockholder and with whose property he was conversant, was quoted at a price far below any figure, based on the value of the metal in the mine or the profits which might be estimated on the most conservative basis.

The dividend policy and many other factors temporarily affect stock market values irrespective of the intrinsic value of ore in a mine. Some of the bases of valuation have been stated as follows:

Method of valuation.—

Regulation. (*a*) Where the fair market value of the property at a specified date in lieu of the cost thereof is the basis for depletion and depreciation deductions, such value must be determined, subject to approval or revision by the Commissioner, by the owner of the property in the light of the conditions and circumstances known at that date, regardless of later discoveries or developments in the property or subsequent improvements in methods of extraction and treatment of the mineral product. The value sought should be that established assuming a transfer between a willing seller and a willing buyer as of that particular date. The Commissioner will lend due weight and consideration to any and all factors and evidence having a bearing on the market value, such as cost, actual sales and transfers of similar properties, market value of stock or shares, royalties and rentals, value fixed by the owner for purpose of the capital-stock tax,[11] valuation for local or State taxation, partnership

[11] The connection of the capital stock tax law with fair values of minerals on March 1, 1913, is remote, to say the least, in view of the fact that the first report under the capital stock tax law was not due until 1917.

accountings, records of litigation in which the value of the property was in question, the amount at which the property may have been inventoried in probate court and, in the absence of better evidence, disinterested appraisals by approved methods. Valuations by analytic appraisal methods, such as the present value method, are not entitled to great weight: (1) If the value of a mineral deposit can be determined upon the basis of cost or replacement value, (2) if the knowledge of the presence of the mineral has not greatly enhanced the value of the mineral property, (3) if the removal of the mineral does not materially reduce the value of the property from which it is taken, or (4) if the profits arising from the exploitation of the mineral deposit are wholly or in great part due to the manufacturing or marketing ability of the taxpayer, or to extrinsic causes other than the possession of the mineral itself. Where the fair market value must be ascertained as of a certain date, analytic appraisal methods will not be used if the fair market value can reasonably be determined by any other method. . . . . (Art. 206.)

The difficulty is that most profitable mining properties have not changed hands since March 1, 1913.[12] In a considerable number of oil properties valuation must be made after that date, where there has been no change of ownership, but a "discovery" value is claimed. Actual sales are often not a criterion. The author knows of a mine which was sold at a price very much above what similar properties in the same district had sold for. The purchaser, however, basing his action on a different operating policy than was used in the district, and on more intensive exploration work, believed the property worth considerably more than the price at which similar properties had changed hands, and backed up his belief by purchase.

The ordinary methods of determining values by comparing sales of similar property have been fully discussed in Chapter XXII. The insufficiency of such methods in valuing natural resources has long been recognized.[13]

The attempt is made to fix the actual sale value of a coal property by examining the price at which other property similar to that under consideration is sold. This method is derived

[12] L. C. Graton, *Federal Taxation of Mines,* page 29.
[13] R. V. Norris, *The Taxation of Income from Wasting Assets.*

from existing methods of real estate valuation and, from an engineer's point of view, is acceptable only when checked or supplemented by a valuation on some other basis. Such checks may demonstrate that recent sales were not made at the actual value of the properties sold.[14]

In the case of coal lands where the value has been based on the results of sales of neighboring properties, it will be advisable to have such valuations supported by other methods of valuation.

Some mineral properties have a certain value because of the ability of the owner to use the product commercially (as in the chemical industry) due to the possession of secret formulae. The denial of any recognized method of valuation in such cases (as appears from article 206) is not justified unless similar property, with like facility of access and operation, can be secured at a nominal price.[15]

Present value method.—

FACTORS TO BE CONSIDERED.—In arriving at the value of a property by the present value method, it has been stated[16] that: "The general principle at the root of the matter is that the annual dividends must yield a good annual interest on the sum invested, and also permit a certain sum to be set aside each year, which securely invested at compound interest, will repay the investment when dividends cease on the exhaustion of the mine."

REGULATION. . . . . (*b*) To determine the fair market value of a mineral property by the present value method, the essential factors must be determined for each deposit included in the property. The factors are (1) the total quantity of mineral in terms of the principal or customary unit (or units) paid for in the mineral product marketed, (2) the average quality or grade of the mineral reserves,

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[14] C. E. Grunsky, *Valuation, Depreciation and the Rate Base,* page 239.

[15] "It is a well settled rule of the courts that values may be determined by expert witnesses. Values are matters of judgment and those most capable of expressing such judgment are persons familiar with the property and the surrounding circumstances at or about the date of valuation." (*Invested Capital of Mining Corporations,* by George E. Holmes, October, 1922).

[16] J. R. Finlay, *Cost of Mining* (1920 edition), page 29.

(3) the expected percentage of extraction or recovery in each process or operation necessary for the preparation of the crude mineral for market, (4) the probable operating life of the deposit in years, (5) the unit operating cost, i.e., cost of production exclusive of depreciation and depletion, and (6) the rate of interest commensurate with the risk for the particular deposit. When the deposit has been sufficiently developed these factors may be determined from past operating experience. In the application of factors derived from past experience full allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the mineral, percentage of recovery, costs of production, and selling price of the product marketed during the expected operating life of the mineral deposit. . . . . (Art. 206.)

The natural resources subdivision claims that the present value of anticipated earnings is now being used for very few coal valuations, that acre values (based on sales) and royalties are being generally used in computing depletion for coal mines.

Following are the conclusions of the American Institute of Mining and Metallurgical Engineers Mines Taxation Committee:

A proper value of a mining property is the present value of the prospective net earnings taking into account probable variations in output and value, discounted by recognized sinking fund methods at a fair rate of interest with sinking fund at 4 per cent interest, or by calculations by standard annuity methods. But other recognized methods of valuation acceptable to the Department may be used.

In lieu of estimated net earnings, where mining on a royalty basis is customary, royalty prices may be used in valuation, taking into consideration the trend of such prices.

As taxpayers, engineers and accountants, during recent years, have had more definite and practical experience in the application of the so-called present value method described above, a question has arisen as to the propriety of the 4 per cent sinking fund requirement. The provision for such a sinking fund in the discount rate results in a lower present value of the anticipated profits and hence a lower depletion deduction. As stated by one of the foremost authorities:

In the practical conduct of mines or mining companies, sinking funds for amortization of capital are never established. In the vast majority of mines of the class under discussion, the ultimate duration

of life is unknown, and therefore there is no basis upon which to formulate such a definite financial policy even were it desired. Were it possible to arrive at the annual sum to be set aside, the stockholders of the mining type would prefer to do their own reinvestment.[17]

Furthermore, the introduction of the sinking fund feature really increases the rate of return on the capital invested.

The elimination of the sinking fund requirement would reduce the problem to the simple one of finding the present value of an annuity.[18]

It seems clear that if the Treasury retains the sinking fund requirement, above mentioned, and thus reduces the taxpayer's value for depletion, it must be more liberal in the interest rates used to represent the expected rate of earning or return on the investment. This question is discussed later in this chapter.

When factors are uncertain.—

Regulation. . . . . (*c*) Mineral deposits for which these factors may not be determined with reasonable accuracy from past operating experience may, with the approval of the Commissioner, be valued in a similar manner; but the factors must be deduced from concurrent evidence such as the general type of the deposit, the characteristics of the district in which it occurs, the habit of the mineral deposits in the property itself, the intensity of mineralization, the rate at which additional mineral has been disclosed by exploitation, the stage of the operating life of the property, and other evidence tending to establish a reasonable estimate of the required factors. . . . . (Art. 206.)

It is recognized that in many cases the factors ideally necessary for a scientific application of the present value method will not be found. In such instances it may become necessary to consider the operating history of the property after March 1, 1913, to determine average assays, gross values, costs, production, etc. These can be checked with the operating results

[17] H. C. Hoover, *Principles of Mining*, page 44.
[18] J. F. Finlay, *Cost of Mining*, page 66. For a discussion as to the decreasing net investment in a mine, see R. H. Montgomery, *Auditing, Theory and Practice*, Vol. I (3rd edition, 1921), page 211. Also *Income Tax Procedure*, 1922, pages 1179-1181.

obtained by other mines in the district. It is well to supplement such data with comprehensive maps, showing the geology and workings.[19]

METHOD OF DETERMINING FACTORS.—

REGULATION. . . . . (*d*) Mineral deposits of different grades, locations, and probable dates of extraction in a mineral property shall be valued separately. The mineral content of a deposit shall be determined in accordance with article 208. In estimating the average grade of the developed and prospective mineral, account should be taken of probable increases or decreases as indicated by the operating history. The rate of exhaustion of a mineral deposit should be determined with due regard to the limitations imposed by plant capacity, by the character of the deposit, by the ability to market the mineral product, by labor conditions, and by the operating program in force or definitely adopted at the basic date for future operations. The operating life of a mineral deposit is that number of years necessary for the exhaustion of both the developed and prospective mineral content at the rate determined as above. The operating cost includes all current expense of producing, preparing, and marketing the mineral product sold (due consideration being given to taxes) exclusive of allowable capital additions as defined in article 222, and deductions for depreciation and depletion, but including cost of repairs and replacements necessary to maintain the plant and equipment at its rated capacity and efficiency. This cost of repairs and replacements is not to be confused with the depreciation deduction by which the cost or value of plant and equipment is returned to the taxpayer free from tax. In general no estimates of these factors will be approved by the Commissioner which are not supported by the operating experience of the property or which are derived from different and arbitrarily selected periods. . . . . (Art. 206.)

The foregoing regulation indicates some of the practical problems encountered. If the deposits vary considerably as to grade, it would be manifestly unfair to the taxpayer to allow only a rate of depletion based on high and low grade ores, when the high grade only is being mined. On the other hand, in a case where the assays were high at March 1, 1913, but in later years declined, the Treasury does not confine itself to what was known at March 1, 1913, but has been known to take the average of a period of years thereafter which was supposed to be representative. Care must be taken, however,

[19] L. C. Graton, *Federal Taxation of Mines*, page 28.

to see that the period selected is really representative and not prejudicial to the taxpayer, and that any abnormal factors in the period are adjusted to represent normal conditions. In most cases the period covered by the war years should be excluded.

The life of the mine affects the value through the discount factor applied—a long life giving a low value, and a short life a high value, compared with the gross value of the mineral contents of the mine. Some of the factors which would determine the life are indicated in article 206 and require detailed evidence to support them. An operating program as at the date of valuation, even if not fully carried out subsequently, would be admissible.

Intensive production means that the units of mineral will be taken out sooner; the annual income in the earlier years contains a greater element of profit, and thus affords the basis for an increased value of the mine. The earlier the mineral is removed and converted into cash, the less is the amount of discount that needs to be deducted from the expected gross realization to reduce to present value at March 1, 1913.

The costs need particularly to be analyzed and any abnormal items not indicative of probable future costs excluded. In some cases the Treasury engineers have deducted large amounts estimated for federal income and profits taxes, which is unwarranted, nor is it required by article 206.

The selling price of the product averaged over a period of years, in order to obtain a normal price, must be considered. Variations in the price, particularly under abnormal conditions, such as have affected silver under the Pittman Act, and copper during the past year with the very great decrease in production, must be fully weighed.

Determination of quantity of ore in mine.[20]—

Regulation. Every taxpayer claiming a deduction for depletion

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[20] For former procedure and comments thereon, see *Income Tax Procedure*, 1919, pages 598-602, 1148-1156 (Supp.).

for a given year will be required to estimate or determine with respect to each separate property the total units (acres, tons, pounds, ounces, or other measure) of mineral products reasonably known or on good evidence believed to have existed in the ground on the basic date, according to the method current in the industry and in the light of the most accurate and reliable information obtainable. Preference shall be given in the selection of a unit of estimate to the principal unit (or units) paid for in the product marketed. The estimate of the recoverable units of the mineral products in the property for the purposes of valuation and depletion shall include as to both quantity and grade (*a*) the ores and minerals "in sight," "blocked out," "developed," or "assured," in the usual or conventional meaning of these terms in respect to the type of the deposit, and (*b*) "probable" or "prospective" ores and minerals (in the corresponding sense); that is, ores and minerals that are believed to exist on the basis of good evidence although not actually known to occur on the basis of existing development; but "probable" or "prospective" ores and minerals may be computed, for purposes of this valuation, (*c*) as to quantity, only in case they are extensions of known deposits or are new bodies or masses whose existence is indicated by geological or other evidence to a high degree of probability, and (*d*) as to grade, of such richness only as accords with the best indications available. If information subsequently obtained clearly shows the estimate to have been materially erroneous, it may be revised with the approval of the Commissoner. (Art. 208.)

In the foregoing instructions it is provided that the estimate must include minerals "assured" and may include prospective or probable quantities. In making this estimate due consideration should be given to the comments on pages 1170 to 1173. In some cases estimates of possible future extraction have been so large (thus extending the prospective removal over an excessively long period) as to make the annual depletion allowance a negligible factor. Such a result proves the inaccuracy of the estimate, as purchases of mines are not made on such a basis.

In one instance where a rock fault in a coal mine subsequently developed, it was held that a material error had been made in the original estimate. In such cases the capital remaining to be recovered should be distributed over subsequent years, on the basis of the last sentence of article 208, Regulations 45, which read as follows:

. . . . If subsequent developments show a material error in the original estimate, a new estimate may be made and the capital remaining to be recovered distributed accordingly. . . . . .

The last sentence of article 208, Regulations 62, however, provides that a revision of the original estimate may be made.

If an erroneous estimate is made and a large amount of tax is paid in the years of high rates (1917 to 1922) and the error is discovered in 1923, it would be equitable to permit the filing of amended returns on the basis of a correct estimate.[21]

Calculation of Value.—

Regulation. . . . . (*e*) The number of units of mineral recoverable in marketable form multiplied by the difference between the selling price and the operating cost per unit gives the total expected operating profit. The value of each mineral deposit is then the total expected operating profit from that deposit reduced to a present value as of the basic date at the rate of interest commensurate with the risk for the operating life, and further reduced by the value at the basic date of the depreciable assets and of the capital additions, if any, necessary to realize the profits. The degree of risk is generally lowest in cases where the factors of valuation are fully supported by the operating record of the mineral property prior to the basic date; relatively higher risks attach to appraisals upon any other basis. (Art. 206.)

If the mine at date of valuation is not equipped, it is customary to discount further the operating profits, on a straight compound interest basis, for the number of years necessary to equip the mine. For example, if two years are necessary to equip the property, the value of the ore is still less, because of the further loss of interest due to the delay.[22]

What is a fair rate of interest?—There seems to be considerable difference of opinion as to what is the proper rate of interest to be used in determining the present value of future earnings, when arriving at the value of mining property as at a specified date.

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[21] For procedure in filing amended returns, see page 87 *et seq.*

[22] H. C. Hoover, *Principles of Mining,* page 48. See also L. C. Graton, *Federal Taxation of Mines* for discussion of fair market value.

It is understood that the Treasury is using 8 per cent for bituminous and 6 per cent for anthracite coal properties. An eminent authority[23] points out that rates vary considerably with the risks involved and summarizes the various rates that have been used by other authorities, as follows:

The proper rate of interest on mining investments has been and still remains the subject of much discussion among engineers. A reasonable solution of the problem has not been advanced and it is the belief of the author that it is not possible to determine a rate of interest that would apply equally well to all mining investments. . . . .

Mr. H. C. Hoover has tabulated the risks of mining as follows (*Principles of Mining*, 1909):

"1. The risk of continuity in metal contents beyond the sample faces.
2. The risk of continuity in volume through the blocks estimated.
3. The risk of successful metallurgical treatment.
4. The risk of metal prices, in all but gold.
5. The risk of properly estimating costs.
6. The risk of extension of the ore beyond exposures.
7. The risk of management."

Several of these risks are found in industrial enterprises (Risks 4, 5 and 7). The risks of continuity of ore body and of ore values are peculiar to the mining industry. The limited market for the mineral products and the effect of the volume of the output on the prices that can be obtained increases the risk that capital must take. The problem of obtaining proper metallurgical treatment is an important one particularly when starting operations at new properties. The fact that the mineral constituents of the ore may change as greater depths are reached and that the previously satisfactory flow sheet may no longer realize the percentage of extraction on which the profits were based cannot be ignored by the investor. The interest return that might be attractive to an investor in a proven district might not be sufficient to attract capital in a district where the mines are still prospects and where the depth of the mineralization has not been tested.

It is a fact that industrial enterprises because of additional risks demand greater interest returns than government bonds and it seems reasonable that mining investments taken as a class should call for a greater rate of interest than industrial enterprises.

This claim for a higher rate of interest is opposed by such an authority on mine valuation as Mr. J. R. Finlay (*Valuation of Iron Mines*, Trans. A. I. M. E., Volume 45, page 295). . . . . Mr. Finlay's

[23] C. E. Grunsky, *Valuation, Depreciation and the Rate-Base*, page 241.

5 per cent interest rate, as applied to the iron mines of Michigan in his appraisal made for the State Tax Commission in 1911, was changed by that Commission to a 6 per cent basis in 1913. . . . .

Mr. Hoover in his admirable work on mine valuation says (*Principles of Mining,* 1909):

"What rate of excess return the mine must yield is a matter of the risks in the venture and the demand of the investor. Mining business is one where 7 per cent above provision for capital return is an absolute minimum demanded by the risks inherent in mines, even where the profit in sight gives warranty to the return of capital."

The Treasury has, in some instances, adopted a higher rate of interest than taxpayers have felt to be warranted. It is noteworthy that an eminent authority in his latest work still maintains that 5 per cent is sufficiently high.[24]

The author is of the opinion that it is impossible to fix a rate of discount for an industry which should be applied to all taxpayers in the same industry. Each case should be treated separately, and the rate fixed in accordance with the risks involved.

In the case of a lessor the contention was advanced by a certain taxpayer that 6 per cent is an equitable rate because the risk is reduced to a minimum on account of a clause in the lease which provides that in case of the failure of the lessee to pay the royalties all rights under the lease will be forfeited together with all improvements made by the lessee.

Since the risk to the lessor is never as great as that to the lessee, the rate of discount should be somewhat lower than that used for determining the value to the lessee.

It must be remembered that the Treasury, in discounting the anticipated profits, uses a formula which provides for interest on the principal sum at one rate, say 10 per cent, and also provides for an annual contribution to a sinking fund, which, accumulated at 4 per cent interest compounded annually, will equal the principal sum at the end of the term. The actual return on the capital sum, however, is greater than 10 per cent due to the introduction of the sinking fund provision.[25]

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[24] J. R. Finlay, *Cost of Mining* (1920 edition), page 66.

[25] For an example of how the sinking fund provision increases the apparent interest rate, see *Income Tax Procedure,* 1922, pages 1190-1191.

Attention has already been called (page 1122) to the fact stated by one of the most eminent authorities, Mr. Herbert C. Hoover, that in the practical conduct of mines and mining companies, sinking funds for the reinvestment in conservative securities of the annual depletion allowances are never established. The Treasury in using the present value of anticipated earnings for determining the value of oil and gas wells[26] does not use the 4 per cent reinvestment factor which it insists shall be used in valuing mines. The author knows of no reason why mines should be thus discriminated against.

Since the depletion deductions return to the mine owner annually a part of his capital, leaving a decreasing sum at risk, it would seem to be sufficient to require interest, i.e., a return each year, only on the decreasing sum and not on the entire capital originally invested.[27]

Illustration of present value method.—An illustration showing the computation of the value of a mine as of March 1, 1913, appears on page 598.

The computations will be varied by the treatment of the various factors employed in a manner to reflect properly normal conditions and the elimination of abnormal items.

Evidence required to support depletion charges.—The law permits a reasonable allowance for depletion and no more. It is proper and necessary that taxpayers should comply with all reasonable Treasury requirements and furnish detailed evidence bearing on the propriety of the deductions claimed.

In addition to the regulations reproduced in full in this book, the Treasury has prepared comprehensive "schedules of depletion."[28] The information which taxpayers are re-

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[26] See also L. C. Graton, *Federal Taxation of Mines*, page 33.

[27] The *Manual for the Oil and Gas Industry*, published by the Treasury Department, contains on page 57, a discount table for computing present values. This table includes no reinvestment feature.

[28] Form D (minerals), form E (coal), form F (miscellaneous non-metals), form O (oil and gas), form P (royalty interests in metal mines), form T (timber). Supplemental forms are required to be filed each year to keep the data up to date.

quired to submit in these schedules or questionnaires includes maps of the property; full particulars of contents and production at March 1, 1913, and subsequently; kinds of ore or mineral produced; manner of acquisition and, when cash was not paid for property, cash value of securities issued; details of appraisals, if any; details of sales of similar properties; estimates of deposits made by engineers or others; assessments for local taxation; sales of securities on exchanges or at private sale; partnership or estate accountings, if any, about March 1, 1913. Various other details are required, all of which are pertinent and proper.

It should be noted, however, that the so-called market value of the securities of a corporation frequently is not a true indication of the fair market value of any particular asset. The courts have so decided on many occasions.

It is understood, however, that the Treasury is most reasonable and does not require or expect special research to answer these questionnaires. Information not affecting the taxpayer's claims is not needed and blanks for this may be ignored.

Revaluation after March 1, 1913, not permitted except in case of discoveries.—At the time the value is being determined, it is important to present all the pertinent data to the Treasury in order to secure the maximum valuation to which the taxpayer is entitled, because after the value is once determined, the regulations provide that a revaluation will not be permitted. It must be remembered that the depletion allowance for all subsequent years is based on such valuation.

It is well settled practice (although disputed by many persons) that appreciation since March 1, 1913, cannot be considered in increasing depletion allowances or reducing the taxable profit arising from sales, except in the case of discoveries.[29]

REGULATION. No revaluation of a property whose value as of the

[29] See page 1132.

basic date has been determined and approved will be allowed during the continuance of the ownership under which the value was so determined and approved except in the case of discovery as defined in articles 219 and 220 or of misrepresentation or fraud or gross error as to any facts determinable on the basic date. Revaluation on account of misrepresentation or fraud or such gross error will only be made upon written application to the Commissioner and approval thereof by him. The value as of the basic date may, however, be corrected when a virtual change of ownership of part of the property results as the outcome of litigation, and may be redistributed (*a*) when a revision of the number of units of mineral in the property has been made in accordance with articles 208, 209, or 211, and (*b*) in case of the sale of a part of the property, between the part sold and part retained. (Art. 207.)

The Treasury has not in all cases adhered to the foregoing regulation; but has reopened valuations by decreasing them, even though no charge of gross error has been made. Taxpayers should be accorded the same right to disregard the regulation.

In a case where the "probable or prospective" ores had not been included in the original valuation, a revaluation was permitted.[30]

The Treasury does not have the power to foreclose a taxpayer's right to review in case of error, except in cases when the right to claim a refund for prior years is barred by statute.

Discovery of mines.[31]—

Fair market value disproportionate to cost.—

Regulation. (*a*) The discovery must add a new mine to those previously known to exist and can not be made within a proven tract or lease as defined in paragraph (g) infra.

(*b*) To entitle a taxpayer to a valuation of his property, for the purpose of depletion allowances, by reason of the discovery of a mine on or after March 1, 1913, the discovery must be made by the taxpayer after that date, and must result in the fair market value of the property becoming disproportionate to the cost. The fair market value of the property will be deemed to have become disproportionate to the cost when the newly discovered mine contains mineral in such

[30] C. B. 4, page 190; A. R. M. 124.

[31] For discovery of oil and gas wells, see page 1146.

quantity and of such quality as to afford a reasonable expectation of return to the taxpayer of an amount materially in excess of the capital expended in making such discovery plus the cost of future development, equipment, and exploitation.

Definition of discovery.—

(*c*) For the purpose of these sections of the Act a mine may be said to be discovered when (1) there is found a natural deposit of mineral, or (2) there is disclosed by drilling or exploration, conducted above or below ground, a mineral deposit not previously known to exist and so improbable that it had not been, and could not have been, included in any previous valuation for the purpose of depletion, and which in either case exists in quantity and grade sufficient to justify commercial exploitation.

(*d*) In determining whether a discovery entitling the taxpayer to a valuation has been made, the Commissioner will take into account the peculiar conditions of each case; but no discovery, for the purposes of valuation, can be allowed, as to ores or minerals, such as extensions of known ore bodies, that have been or should have been included in "probable" or "prospective" ore or mineral,[32] or in any other way comprehended in a prior valuation, nor as of a date subsequent to that when, in fact, discovery was evident, when delay by the taxpayer in making claim therefor has resulted or will result in excessive allowances for depletion. . . . . (Art. 219.)

When improvements in processes of treatment make valuable certain ores previously of no value the Treasury recognizes that exploration for such ores will be stimulated, hence "discovery" is made; but it is unwilling to allow a discovery value of the same kind of ores known to exist in the mine before the improvement in process made the ores valuable.[33]

If a purchaser of low grade ore finds a body of high grade ore, surely it is a discovery. It may be, however, that the term will be strictly interpreted in view of the intention of Congress to extend what may be characterized as a tax privilege.

In the case of mines having an extensive development program, there is always the possibility that a claim for discovery value may be made if sufficient data is secured to prove that

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[32] See page 1126.

[33] C. B. 4, page 190; A. R. M. 124. For text see *Income Tax Procedure, 1922*, pages 1195-1196.

the newly developed ore could not have been comprehended in a previous valuation.

VALUE 30 DAYS AFTER "DISCOVERY" MUST BE REASONABLY CERTAIN.[34]—

REGULATION. . . . . (*e*) The value of the property claimed as a result of a discovery must be the fair market value, as defined in article 206, based on what is evident within thirty days after the commercially valuable character and extent of the discovered deposits of ore or mineral have with reasonable certainty been established, determined or proved.

CAPITAL ACCOUNT TO BE ADJUSTED.—

(*f*) After a *bona fide* discovery the taxpayer shall adjust his capital and depletion accounts in accordance with articles 206, 208, and 210, and shall submit such evidence as to establish his right to a revaluation, covering the conditions and circumstances of the discovery and the size, character, and location of the discovered deposit of mineral, the value of the property at the prior basic date, the cost of discovery, and its development, equipment, and exploitation, its value and the particular method used in the determination.

PROVEN TRACT OR LEASE.—

(*g*) In the case of a mine, a "proven tract or lease" includes, but is not necessarily limited to, the mineral deposits known to exist in any known mine at the date as of which such mine was valued for purposes of depletion, and all extensions thereof, including "probable" and "prospective" ores considered as a factor in the determination of the value or cost. (Art. 219.)

Valuation of Oil and Gas Wells[35]

In the foregoing pages dealing with the valuation of mines, the general principles underlying the valuation of mineral properties for purposes of depletion have been explained. The following discussion refers to some of the particular problems found in the valuation of oil and gas wells.

In view of the highly technical regulations relating to the gas and oil industries the Treasury has prepared an exhaustive

[34] See page 1146.
[35] For former procedure and comments thereon, see *Income Tax Procedure,* 1919, pages 602-609, 1156-1164 (Supp.).

treatise which should be consulted by all interested.[36] Therefore articles 206 (a), 209, 211-214, 218, 220, 220 (a), 221, 223 and 226 are omitted from this chapter.

Among petroleum engineers the recognized method of appraising an oil or gas property for tax purposes is on the basis of past production of similar properties in the same sand and pool or geographical district. The authority for this method is the law of equal expectations, which is as follows: "If two wells under similar conditions produce equal amounts during any given year, the amounts they will produce thereafter, on the average, will be approximately equal, regardless of their relative ages."[37]

Production decline curves.—The past production of individual wells may be graphically represented by production decline curves which depict the decline in the production of a well over the period of its existence. Such curves are constructed on co-ordinate paper with evenly spaced divisions, the vertical scale indicating units of production, the horizontal scale representing years. The curve for an oil well is symmetrical. The decline of production in the first year of the well's existence is very rapid but the slope gradually subsides until it approaches the horizontal. All oil curves are of this type. Wells with a large first year production decline more rapidly than wells with a small initial production. The curve for a gas well approximates that of an oil curve, but it is less likely to be symmetrical.

The unit of production in the case of oil is the barrel. There is little difficulty in obtaining the records of the production for this unit as the production of a lease is generally measured on the lease by the flow of oil into tanks. Royalties, the equivalent of rents, on oil leases are almost universally

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[36] The book contains 245 pages and is entitled *Manual for the Oil and Gas Industry*. Copies may be obtained from the Superintendent of Documents, Washington, D. C., for 25 cents each.

[37] *Manual for the Oil and Gas Industry* (1921), page 73; and *Bureau of Mines Bulletin* 177, by Carl H. Beal (1919), page 36.

based on production, the lessor usually receiving the value of one-eighth of the production.

There is a different situation with gas. The production unit is a thousand cubic feet. Royalties consist of fixed payments each year or payments based on pressures taken at the well. There are numerous instances where producers do not meter their gas at the lease and it is not metered until it reaches the consumer. This is not fatal if the producer has accurate pressure records from which the production of a well for the year may be calculated. Where there are not accurate pressure records the appraiser should check his estimate of production in the field by adding to the total volume of metered gas the line losses, or leaks from the pipe lines carrying the gas, and such other losses between the wells and the meters, as free gas to the lessor and gas used by the lessee for drilling purposes.

Line losses are difficult to estimate when the production in the field is not known. They vary according to the weather, condition of the pipe line, and the type of pipe line. Line losses in a city are apt to be large because of the frequent connections made for each house or factory. Welded lines show less loss than other types. Leaks are more frequent in the winter than in the summer. It is obvious that with such difficulties at the outset the estimate of the gas which a well will produce is subject to a large percentage of error.

Having constructed decline curves for the individual wells, the next step is to construct a composite production decline curve for a given sand in a given pool or district. The *Manual for the Oil and Gas Industry* (page 86) recommends that the family curve be used. The family curve is constructed by selecting the largest producing well in the pool, and, using that as a basis, putting the production of the second largest well with its first year's production on the curve of the first well, the third in the same way, and so on. An average curve is constructed giving due weight to the variations of each well. There is a considerable personal equation involved in this

method with the consequent danger of error. It is laborious and difficult to accomplish neatly. Some engineers have found that the segmental method is a short and fairly accurate method of constructing a composite decline curve. This consists of averaging the periods of time for declines between selected points of production. The months or years required by all the wells to decline from a production of, let us say, 100 to 90, 90 to 80, 80 to 70, etc., are read from the individual well curves and averaged by dividing the total amount of time by the number of producing wells.

Great care must be exercised in selecting the wells to be used in the composite production decline curve. All aberrant or erratic wells such as those which show the effects of water, which are abandoned after short periods, and which are drilled too closely to one another, should be excluded. In making individual curves for gas wells the appraiser should exercise caution in selecting pressures upon which to calculate yearly production. The majority of Appalachian producers who supply domestic consumers shut in some of their wells during the summer months as the demand for gas is low, practically none being required for heating purposes. The effect of shutting in the wells is to increase the pressures. In the winter pressures are low, due to the cold weather and the heavy drain on the fields made necessary to supply the consumers with gas for fuel. In general the pressures at the end of September are representative pressures upon which a calculation of the year's volume may be properly based. Abnormally low pressures due to the presence of water in a well or sudden high pressures due to the abandonment of nearby wells should be disregarded.

The composite production decline curve represents the decline in production of the average well in a given sand, or stratum, and in a given geographical district. To obtain the estimated future production of a well, the point on the composite decline curve corresponding to the yearly rate of production as of the date of valuation of the well is located and the future production is read off, year by year, to the economic

limit. The economic limit is that point where the production is so small that the producer makes no profit by operating the well. The economic limit varies according to the profit on the commodity. The sum of the future production, year by year, equals the estimated recoverable reserves, or the amount of oil or gas which the taxpayer expects to produce.

There are several other types of curves which may be used in valuing oil and gas properties.[38]

Gas pressure may be utilized for estimating the future production of oil wells, as in the case of gas wells. The investigations of the Bureau of Mines seem to indicate that the rate of production of oil is dependent upon the expulsive force of the gas accompanying the oil. Accordingly, it is within the realm of possibility to make future production decline curves for oil wells based upon initial gas pressures. A practical difficulty would be the fact that few companies which produce only oil keep a record of the gas pressures of their oil wells.

Field prices and costs.—Prices are estimated for the oil or gas unit of production on the lease. The taxpayer places a value on his well or lease, taking into consideration the transportation facilities available. It is essential in predicting future prices, especially in the case of oil, that the engineer be acquainted with the supply of and demand for the commodity. In recent years price curves depicting the rise in price of oil since the year 1900 extrapolated, or extended, into the future with the same percentage of increase, have been unsatisfactory because of the sudden drop in the price of oil at the beginning of 1921. This type of prediction has been successful for the prices of gas in the Appalachian region. In this section the gas reserves seem to be steadily declining with no new pools being discovered. One company had one-

[38] "Some Principles Governing the Production of Oil Wells," by Carl H. Beal and J. O. Lewis, *Bulletin* 194 (Bureau of Mines). "Relation of Drilling Campaign to Income from Oil Properties," by W. W. Cutler, Jr., and Walker S. Clute, *Reports of Investigations* No. 2270 (Bureau of Mines).

third less production in 1920 than in 1916, although it had about 30 per cent more wells producing in 1920. The producers are educating the people in methods of conservation and at the same time gradually increasing the prices against the day when there will be no natural gas resources and the people must use artificial gas, which is more expensive. Some of the cities of Pennsylvania which formerly used natural gas for fuel have had to turn to coal. This situation indicates that the taxpayer in the Appalachian field is safe in assuming that the price of gas will rise steadily for the next few years.

Where a producer does not sell his gas in the field to a pipe line company, and has only a consumer's price, there is the same difficulty in estimating a field price as there is in estimating field production when there are no pressure records. Field prices must then be estimated by deducting from consumers' prices the value of line losses, free gas, and gas used for drilling or other purposes.

Production costs include the cost of drilling, maintenance, and transmission of the product to the lease boundary. The appraiser should be cautious about estimating his future costs on the basis of the rise in the past because of the inflation of prices of materials during the period of the recent war.

The field price per unit of production minus the production cost in any year, equals the future net revenue for the unit in that year. The future net revenue for the unit for a year times the estimated recoverable units of production for the year, equals the net revenue for the property in the year.

In determining a future field price of oil the appraiser should keep in mind the fact that the production of petroleum by the present-day methods will ensure an adequate supply to the country only for the next decade. The Bureau of Mines estimates that the present-day method of recovering oil obtains only 10 to 20 per cent of the oil contents of a producing sand. Carelessness in drilling, the encroachments of water, and the escape of expulsive gases accompanying oil before the oil has been produced, are some of the factors which tend to minimize

the present-day production. The prospect of increasing the casing head gasoline production is not very favorable, since most of the regions which produce the best gas for casing head gasoline extraction have been thoroughly exploited at the present time.

Some remedies for the situation have, however, been discovered. Several years ago it was found that when a new well was drilled in the center of an old field, old oil wells which had not been producing for some time would resume production. This was thought to be due to the atmospheric pressures exerted on the oil-producing sand in the new well. This led to the Smith-Dunn process of forcing compressed air down a central well and thereby increasing the production of surrounding wells. Another method of increasing the production of oil wells is by flushing the producing sands with water so that the oil is forced up in the old wells. There are possibilities of conserving the oil supply by the invention of new types of gasoline engines which will not require the large consumption now demanded and by other devices aimed to do away with the waste of petroleum. There is also the possibility of the development of a process by which oil shale may be mined and the oil extracted at a cost so cheap that it may be of commercial value. The oil shale industry has been successful in Scotland for half a century. However, it is not at present an important factor in world production. The industries in Scotland are located near large cities whose petroleum supply is drawn from the imports from the United States. The oil shales in the United States are located in the Rocky Mountain region, where there are numerous oil fields. The progress of the oil producers along the lines suggested above should be kept in mind when an attempt is made to predict the future prices of oil.

Another factor which the appraiser must recognize is the fact that oil prices are fixed for the whole country or a whole region by a few large companies, whereas the prices of gas

are usually determined by the public service commission of the state for each individual company.

Present value method.—To obtain the present worth of the property discount factors of from 8 to 10 per cent are used.

In addition to the discount to obtain the present value, a "discovery" well should be further discounted for the risk of abandonment, which is the risk that natural forces, such as water, will prevent the actual production equalling the anticipated production, and the risk of offset wells, that is, the risk that rival producers will drill so close as to drain a portion of the resources of the well.

The discount table published by the Treasury[39] is based on the present value of $1 due a number of years hence, the present value being worked out for each year separately. The sum of the present worths for each year is the total value to be ascribed to the property. The necessity for discounting each year's income separately is that production in an oil property progressively declines, whereas in a mine it is assumed to be fairly constant year after year. The discount table contains no reinvestment feature as is the case in the tables used for mines; that is, no provision is made for establishing a theoretical sinking fund at 4 per cent compounded annually, as in the case of mines, which results, of course, in a greater present value being assigned to the property. As stated by the Treasury, "The rate of discount employed depends upon the judgment of the person making the valuation."[40]

Risks affecting rate of return.—Some of the ordinary risks to be considered in valuing oil and gas properties are:

1. For wells valued as of March 1, 1913:
   (a) Risk of abandonment, or the risk that natural forces will prevent the actual production equalling the anticipated production.

[39] *Manual for the Oil and Gas Industry,* page 57.
[40] *Manual for the Oil and Gas Industry,* page 58.

(b) Risk of offset wells, or the risk that rival producers will drill producing wells so close to the property as to drain a portion of the resources.

2. For discovery wells:
   (a) Risk of abandonment.
   (b) Risk of offset wells.
3. For undrilled locations:
   (a) Risk of dry holes.
   (b) Risk of abandonment.
   (c) Risk of offset wells.

Valuation of undrilled acreage.—A fair method of valuing undrilled acreage surrounding a well is on the basis of the drilling program which any experienced producer would inaugurate. The drainage area of a well varies as to its locality and the porosity of the sand. In the Appalachian field an oil well drains about eight acres and a gas well approximately forty acres. Using the drainage area of the well as a basis, the appraiser indicates on a map the territory which he expects to be drilled, taking into account the geological conditions, the practical difficulties, and the necessity of placing the wells in such positions that they will drain the maximum amount from the taxpayer's territory at the least cost, and at the same time be as near the lease boundaries as possible in order to drain neighboring leases held by rival producers.

The drilling of offset wells is recognized as a proper procedure in the oil and gas industry. Oil and gas have been classified by the courts as minerals *ferae naturae* in view of the propensities of these products to flow through a sand.[41]

One theory on the drainage of oil is that, when a well is the first to be drilled in a pool, channels in the sand are formed in all directions from the bottom of the well and the oil reaches the well by means of these channels. Under these circumstances it is not infrequent for surrounding wells drilled later

[41] For summary of decisions on this point, see I-36-487; L. O. 1103.

to fail to overcome the effect of these channels, and the first well may continue to draw production from areas which immediately surround later wells but it is not able to extend its channels any further in the direction of the offset well.

Well spacing is influenced by the thickness and the character of the sand, rock pressure, and the character of oil. The necessity of drilling offset wells may also intervene in spacing of wells. The price of oil is also a factor. If prices are low the operator is not inclined to drill many wells, but rather feels that he should save his oil until prices are higher. When prices are high the operator drills more wells, as he wishes to get the maximum income, if possible, even though his initial productions per well are smaller. However, where there are tight or irregular sands close spacing does not seem to make any difference in the ultimate production of the discovery well. Where a thick, heavy oil is produced close spacing does not affect the original well.

The value of a location for a future well should be discounted for deferment, the risk of a dry hole, the risk of abandonment, and the risk of offset wells. The risk of deferment is the risk that the rate of production for the field will be smaller than its present rate at the time the proposed well is drilled. The risk of a dry hole is the risk that the proposed well will not produce any gas or oil at all.

Loss from storage.—When an oil company stores oil in large quantities for long periods of time, an oil production risk, which the appraiser should take into consideration, is the loss which may occur from such storage. When oil is stored in large quantities there is a considerable danger of fire, caused by explosions resulting from lightning. Frequently large reservoirs are made in the earth without being properly lined. In such cases there is a very large loss from seepage.

Gasoline.—In recent years producers have found that sometimes they can absorb gasoline from the gas as it comes

from the well. Where the producer has indicated by the presence of an absorbing plant his intention to take out the gasoline at the date of valuation, or shortly thereafter, he may claim depletion on the gasoline contents of the gas, as well as on the gas itself.

A refiner may have a large number of contracts for the purchase of gasoline at the wells. It is understood that he is allowed to deplete the value of these contracts. Apparently the reason for this is that the refiner has a legal interest in the mineral content of the well similar to that of the lessee who is allowed to claim depletion for the value of his rights. Depletion of such contracts, however, would be permissible only if they were held at March 1, 1913, or were acquired since for a valuable consideration.

Evidence required to support depletion charges.—Although the oil and gas taxpayer reaps many benefits under the income tax law as it now stands, he must also undergo considerable expense in meeting the requirements of form O to support his claims for depletion and depreciation. The information required is not likely to be kept in such form by the taxpayer that he can readily produce it. It has required some companies three years, with a staff of twenty men and girls working continuously, to complete amended returns from 1913 to date. Detailed information as to each lease is required. When a taxpayer has three or four thousand leases, this information is in itself a burden. The most unreasonable requirement is that a taxpayer show development in the neighborhood of his discovery. This is in effect compelling him to wrest information from his rivals. Probably the Treasury Department is not particular as to this feature today, as the government maps showing development are understood to be in good shape. In the case of discovery wells the Treasury Department asks for the true bearing and distance of all wells within 3,733.5 feet of the discovery. In thickly drilled fields this is almost impossible of accomplishment. The information as to true bearing

should be eliminated, since the Treasury holds under the law that ordinarily a discovery proves a maximum area of 160 acres.

So-CALLED "SCIENTIFIC" METHODS NOT CONTROLLING.—The law does not provide or imply that the operator shall use the complicated methods now in vogue with the Bureau of Mines in arriving at the valuation. The methods used in valuing property by the Bureau of Mines are undoubtedly those which should be used in considering the oil and gas industries for the country as a whole or for any particular region. However, when operators in the field have methods by which they determine the selling price of a well in a very short time, the complicated calculations which the taxpayers are now forced in effect to use do not seem to be justified. In the ordinary case the market value of an individual well would not be determined by the use of production decline curves and the refinements they entail.

Suppose an operator in West Virginia wishes to buy a well which has an initial flush production of 1,000 barrels. He discounts that figure for flush production at 50 or 75 per cent, depending upon what he believes is the rate at the time in that field. He then puts a price per barrel-day upon the well. At this time the price is about $3,000 per barrel-day for most sections in West Virginia. If the settled production is 500 barrels per day the well is worth $1,500,000. The assessments made by some states for tax purposes are based upon a figure for a barrel-day production on December 31 of each year. The operator also considers the amount of acreage which he will get with the well in determining his barrel-day price. In the case of gas wells the operator's appraisal is not so clearly made. There does not seem to be any price for a gas well based upon units of production per day. In valuing a gas well the operator considers the rock pressures, believing that the production of the well declines at the rate the rock pressure declines. He also considers the current field prices

and protection acreage. The operator in the Appalachian field believes an oil or gas well should pay for itself in three or four years.

If the valuation is to be the market price, the market price should be determined by the oil man's method rather than by the long approximation of the oil man's methods used by the Bureau of Mines.

Revaluation after March 1, 1913, not permitted except in case of discoveries.—The comments on page 1131 apply equally to oil and gas wells. Article 206 (A) is therefore omitted.

Discovery of oil and gas wells.—

FAIR MARKET VALUE DISPROPORTIONATE TO COST.—In the case of oil and gas properties it is understood that the Treasury Department requires that the fair market value of the property must exceed the cost by at least 100 per cent.

The law,[42] however, does not fix any definite percentage by which the fair market value must exceed the cost. It reads "where the fair market value is *materially* disproportionate to the cost."

PROVEN TRACTS IN RELATION TO DISCOVERY CLAIM.—The Treasury interprets the law allowing revaluation on account of discovery as meaning that a discovery well ordinarily proves an area of 160 acres of a sand regardless of private boundaries, or in other words, a producing well indicates that there is a reasonable certainty that the area of 160 acres around the well contains oil and gas in sufficient quantities to justify its exploitation.[43]

The discovery provision of the law was originally enacted to protect the adventurous oil men who drilled wild-cat wells, or who drilled and opened up undeveloped territory. As such

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[42] Sections 214 (a-10) and 234 (a-9).
[43] *Manual for Oil and Gas Industry,* page 44, first paragraph.

producers take large risks their returns should be large. The original interpretation of the law was that a discovery well proved a pool or geographical district. The more recent rulings of the Treasury indicate that a proven area is limited to 160 acres.[44]

Comment on the regulations.—The expressed purpose of the law is to permit annual allowances for depletion, based on output, up to the cost of the wells, and the intention of the numerous rulings and regulations has been to carry out the provisions of the law. The most that any owner can desire to charge off against income is the fair value of the property March 1, 1913, or the entire cost of property acquired or the fair value of discoveries since that date. He recognizes that any net income realized in excess of such amount is profit and should be taxable.

In some cases owners desire to charge off too much annually and in other cases they do not charge off enough. Those who charged off too much prior to January 1, 1917, regret their action because there is now so much less left to claim as allowable deductions under laws levying higher taxes. On the other hand, conservative financing and accounting require liberal reserves for depreciation and depletion, and the concern which has followed this policy should continue it and make such adjustments between the books and the tax returns as will reflect the true state of affairs. An oil company with a large cash investment cannot afford to ignore depletion or exhaustion. Aside from new purchases, it is obvious that at the end of any period the product remaining in the ground is less than at the beginning of the period by exactly the amount which has been extracted.

New wells brought in may increase flow and there may be an apparent appreciation in values rather than depreciation, but when such hazardous properties as oil wells are under consideration the tendency of good managers is to be pessimistic

[44] For illustrative examples, see *Income Tax Procedure*, 1922, page 1206.

about the future and to be liberal in setting up depletion reserves. This policy prevents the overstatement of assets and the payment of excessive dividends. It may save a company from bankruptcy. The government will not lose anything in taxes in the long run by permitting liberal depletion deductions. It will probably gain, because the instant the entire investment is written off the books no further deductions for depletion can be claimed and under graduated income tax laws the aggregate tax is increased. From the taxpayer's point of view, it is better to pay too much tax in the long run and have a conservative balance sheet, than to ignore depletion or provide insufficient reserves and publish misleading balance sheets.

Determination of the Depletion Allowance

Having determined the value of the property as at the date of valuation (the "basic date"), the next step is to determine the depletion unit, which is ascertained by dividing the value of the property by the number of units of mineral estimated to be in the property. The unit value multiplied by the numbers of units sold during the year gives the depletion allowance.

REGULATION. (*a*) Depletion attaches to the annual production "according to the peculiar conditions of each case" and when the depletion actually sustained, whether legally allowable or not, from the basic date, equals the cost or value on the basic date plus subsequent allowable capital additions, no further deduction for depletion will be allowed except in consequence of added value arising through discovery or purchase. . . . .

(*b*) When the value of the property at the basic date has been determined, depletion sustained for the taxable year shall be computed by dividing the value remaining for depletion by the number of units of mineral to which this value is applicable, and by multiplying the unit value for depletion, so determined, by the number of units sold or produced within the taxable year. The depletion deduction for the taxable year is subject, however, to the limitation contained in article 201 (*h*).[45] In the selection of a unit for depletion preference shall be given to the principal or customary unit or units paid for in the product sold.[46] (Art. 210.)

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[45] See page 1152.

[46] **[Former Procedure]** Before the revision of December 29, 1920.

In (a) "production" is mentioned, but in (b) reference is made to the "units sold or produced." It is obvious that the quantity extracted represents actual depletion, because coal and other natural resources are frequently consumed by the taxpayer and not sold.

Depletion of mines.—In copper mines the practice is to multiply the depletion factor by the number of net tons of ore smelted or by the number of pounds of metal recovered or produced from ore smelted.[47]

In establishing the depletion rate care must be taken to use a rate that will provide for the proper deduction based on the grade extracted. If high grade ore is extracted during the early years, and low grade in the later years, an average rate might fail to recover the full capital because in the later years the income might be insufficient.[48]

The point is that the extraction of 100 pounds of copper contained in rich ore results in a greater impairment of the mine, because of the greater profit in the high grade ore than does 100 pounds of copper in low grade ore in which there was little profit. The problem may be solved in some cases by separate valuations of the various blocks of ore, where it is feasible to do so, as provided in article 206, and the establishment of separate depletion rates applicable to each.[49]

In the case of a silver mine, this situation was recognized by basing the depletion, not on the tons of ore contained in the mine, but on the metal content of the ore. The unit of depletion was, therefore, the ounce of silver instead of the ton of ore containing silver. Each year's depletion allowance is

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article 210 of Reg. 45 provided for computing the depletion allowance based on the number of units *extracted* during the year. See *Income Tax Procedure,* 1920, page 770.

Reg. 45 (1920 edition), article 210, based the allowance on number of units *sold*. See *Income Tax Procedure,* 1921, pages 936-937.

[47] T. O. McGrath, *Mine Accounting,* page 72.

[48] L. C. Graton, *Federal Taxation of Mines,* page 57.

[49] Recovery of the cost or March 1, 1913, value of the physical property may also be obtained through a depreciation deduction, based on the rate of current exhaustion of the mineral See page 1047.

based on the silver recovered (allowance having been made in the basic valuation for expected loss in extraction), which naturally varies as between different grades of ore. Note particularly the last sentence of article 210. The unit paid for in the product sold by a silver mine is not ore but silver; by a copper mine, not ore but copper, etc.

Methods of depletion.—The following is from a recent statement on the subject:[50]

> Two formulas have been advanced—(1) that depletion should attach to each unit in the mine at a fixed amount, this amount to be arrived at by dividing the base (cost or valuation) by the estimated number of units. The other formula is (2) that depletion should attach to the operating profits at a fixed rate, to be taken in cases of valuation as a percentage of the year's operating profits equal to the ratio of the capital remaining to be recovered through depletion to the expected operating profits remaining to be realized at the end of the taxable year.
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> The former of these methods has been adopted in the Regulations . . . . and is to date the only formula recognized.
>
> The latter has been advocated as a fairer method and is now under discussion by members of the Division of Natural Resources. . . . . It is claimed . . . . that it will insure the payment of an income tax in all years, where there are any operating profits. In high profit years, the percentage method allows a greater tax-free deduction; in no profit years there are no deductions to be written off or carried forward as losses.[51]

The method of computing depletion prescribed by the regulations has been attacked on the ground that it ignores the position in the earth of the unit, and the date when it is mined "whether in years of high or low prices or costs."

In years when the operating income, before depletion, is less than the depletion charge, there is reported taxable income even though the books show a net loss after depletion. In other years (if experience confirms the original estimate) the taxable income reported will be less than the book net income.

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[50] *Distribution from the Depletion Reserve* by Paul Armitage, address before American Mining Congress, Cleveland, Ohio, October 1922, pages 4-5.

[51] For an illustration of depletion computed on a percentage of operating profits, see *Depletion* (November, 1922), by R. V. Norris, pages 6-9.

Under this method the tax burden is more scientifically distributed over the life of the wasting asset; but as estimates rarely work out exactly it may not be feasible to adjust the plan to our changing tax system.

Depletion of gas wells.—When gas wells have been valued on the basis of production, it is more practicable to use the production for calculating depletion for any given year than the pressure units suggested by the Treasury Department.[52] Depletion on the basis of production is the depletable capital sum divided by the estimated recoverable reserves (which equals the unit cost), times the number of cubic feet of gas produced during the year.

Depletion of oil wells.—

> Each barrel of oil or unit extracted and marketed must, before a profit can be realized, pay not only its proportionate share of the operating expense and deductions for depreciation and obsolescence of physical property, but also must pay its proportionate share of capital sum returnable through depletion allowances.
>
> This proportionate share of capital sum returnable through depletion allowances, which each unit of oil must pay, is unit cost.
>
> Unit cost is obtained by dividing the capital sum returnable through depletion by the "estimated recoverable reserves" at the beginning of the taxable year. . . .
>
> The depletion deduction is computed by multiplying the unit cost by the number of units produced during the taxable year.[53]

While the Treasury refers to units produced, as above, it also provides, in article 210, that depletion shall be computed on the number of units *sold* or *produced* during the year.

Limitation on depletion deduction based on discovery value.—The 1921 law[54] does not permit any part of the depletion deduction based on discovery value to be used in the computation of a net loss. This prevents the loss from being deducted from the income of a succeeding year, due probably to the "discovery" provision (which is first found in the 1918

[52] *Manual for the Oil and Gas Industry* (1921), page 32.
[53] *Ibid.*, page 30.
[54] Section 204; see page 967.

law) being considered to be in the nature of a gift; and if the net income in any one year is not sufficient to take care of the full depletion charge based on discovery, there is no good reason for extending the terms of the gift to another period.[55]

REGULATION. . . . . (*h*) Depletion allowance in case of discovery: The deduction for depletion in case of a discovery can not exceed the net income computed without allowance for depletion, from the property upon which the discovery is made, except where and to the extent that such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913. Net income is the gross income from the sale of all mineral products and any other income incidental to the operation of the property for the production of the mineral products, less operating expenses, including depreciation on equipment, and taxes, but excluding any allowance for depletion. If the mineral products are not sold as raw material but are manufactured or converted into a refined product, then the gross income shall be assumed to be equivalent to the market or field price of the raw material before conversion. Operating expenses, depreciation, and taxes on the property upon which the discovery is made, should be applied against the gross income from the same property on the basis of actual expenditures, but if the records for the year 1921 are in any case inadequate, allocation of such expenditures for that year may be made on the basis of the ratio of (1) the number of wells operated on the property on which the discovery is made to (2) the total number of wells operated in the operating division in which the discovery is included. (Art. 201.)

The following illustrations show how the limitation operates:

I

Net income from investments		$10,000
Net income from mineral property before depletion		50,000
Total		$60,000
Depletion charge based on cost or March 1, 1913, value	$40,000	
Depletion charge based on discovery value	$80,000	
Depletion allowable (amount of depletion charge based on discovery value, but not to exceed the net income from the property)		50,000
Taxable income		$10,000

[55] For a comprehensive argument that Congress granted the allowance "as fairly representative of the capital investment," see *Distributions from the Depletion Reserve* by Paul Armitage, address before American Mining Congress, Cleveland, Ohio, October 1922, pages 41-52.

II

Net income from investments		$10,000
Net income from mineral property before depletion		50,000
Total		$60,000
Depletion charge based on cost or March 1, 1913, value	$60,000	
Depletion charge based on discovery value	$80,000	
Depletion allowable (amount of depletion charge based on discovery value, which, if it exceeds net income from the property, is allowed up to the amount of depletion based on cost or March 1, 1913, value)		60,000
Taxable income		None

III

Net income from mineral property before depletion (no income from other sources)		$50,000
Depletion charge based on cost or March 1, 1913, value	$60,000	
Depletion charge based on discovery value	$80,000	
Depletion allowable (as above)		60,000
Net loss (which may be applied against net income of succeeding year—section 204)		$10,000

IV

Net income from investments		$ 5,000
Net income from mineral property before depletion		50,000
Total		$55,000
Depletion charge based on cost or March 1, 1913, value	$60,000	
Depletion charge based on discovery value	$80,000	
Depletion allowable (as above)		60,000
Net loss (which may be carried forward—section 204)		$ 5,000

The point is that the taxpayer may get depletion based on discovery value, if the net income is sufficient, but always gets depletion based on cost or March 1, 1913, value even if it results in a net loss, which net loss may be applied against the net income of a succeeding year under section 204.

Inventory at market even though higher than cost.—If raw products are inventoried at the market price, as permitted by article 201, the latter may include a considerable

element of profit. In so far as this may be a method recognized as representing the best accounting practice in the industry, it will be recognized by the Treasury. It is a good illustration of one of the five departures from the rule of cost or market, whichever is lower.[56]

Depletion accounts on books.—

Regulation. Every taxpayer claiming and making a deduction for depletion and depreciation[57] of mineral property shall keep accurate ledger accounts in which shall be charged the fair market value as of March 1, 1913, or within thirty days after the date of discovery, or the cost, as the case may be, (*a*) of the mineral deposit, and (*b*) of the plant and equipment, together with subsequent allowable capital additions to each account. These accounts shall thereafter be credited annually with the amounts, whether legally allowable or not, of the depletion and depreciation sustained; or the amounts of the depletion and depreciation sustained shall be credited to depletion and depreciation reserve accounts, to the end that when the sum of the credits for depletion and depreciation equals the value or cost of the property, plus subsequent allowable capital additions, no further deduction for depletion and depreciation with respect to the property shall be allowed. (Art. 216.)

The Public Service Commission of Pennsylvania has published a book entitled, "Uniform Classification of Accounts for Natural Gas Companies." This book has been approved in other states. It does not provide for discovery revaluations but rather asks for the cost as the proper valuation. Thus the taxpayer must carry two sets of values for the same assets, one set being the cost value of his property with depletion calculated upon such cost for the benefit of the state authorities, the other being a value containing discovery revaluation with depletion calculated thereon for use in a federal income tax return.

Another difficulty lies in the fact that the Federal Act allows the taxpayer to charge development expenses, that is,

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[56] See *Auditing, Theory and Practice*, Vol. I (1921 edition), by R. H. Montgomery, page 122.

[57] See page 1046-1049 for articles 222, 224 and 225 which refer to depreciation as well as depletion in connection with equipment.

expenses of drilling wells, to either expense or capital. The Pennsylvania classification indicates that the producer shall charge development costs only to capital. If the producer has elected under the Federal Act to charge development costs to expense, he must nevertheless charge development costs to capital on his books in order to satisfy the public service commission.

It cannot be expected that the public service commissions in fixing natural gas rates will allow the gas producer to deduct this inflated depletion on account of discovery revaluation as part of his expenses of supplying gas to domestic consumers. The points of view of the federal government and the state public service commissions are substantially different. The federal government allows depletion on discovery revaluations in order that high taxes may not discourage the oil and gas operator from developing new territory. The purpose of the public service commission is to render justice to producer and consumer so that the operator must be content with depletion of costs.

Statement to be attached to returns.—

Regulation. (*a*) To the return of every taxpayer claiming a deduction for depletion or depreciation there shall be attached a statement setting forth with respect to each mineral property: (1) Whether taxpayer is a fee owner, lessor or lessee; (2) the date of acquisition and if under lease, its exact terms and date of expiration; (3) the cost of the property, stating the amount paid to each vendor, with his name and address; (4) the basic date at which the property is valued; (5) the value of the property on the basic date with a statement of the precise method by which it was determined; (6) the value of the surface of the land for purposes other than mineral production; (7) the estimated number of units of mineral at the basic date with an explanation of the method used in the estimation, and an average analysis which will indicate the quality of the mineral value; (8) the number of units sold during the year for which the return is made; (9) the gross and net income derived from the sale of mineral and in case of discovery the net income from the property upon which the discovery was made; (10) the amounts deducted for depletion; (11) the amounts sustained on account of depletion or on account of depreciation stated separately from the basic date to the taxable year;

and (12) any other data which will be helpful in determining the reasonableness of the deductions claimed in the return.

ADDITIONAL INFORMATION IN CASES OF FRACTIONAL INTERESTS AND LEASEHOLDS.—

(*b*) To the return of every taxpayer claiming a deduction for depletion in respect of (1) property in which he owns a fractional interest only, or (2) a leasehold, or (3) property subject to lease, there shall also be attached a statement setting forth the name and address and the precise nature of the holding of each person interested in the property, and every lessor shall attach to his return an affidavit stating, as of the date of filing the return, whether the lease involved is still in effect during the year covered by the return, and, if not still in effect, when it was terminated and for what reason and whether the lessor has repossessed the property.

(*c*) All statements required to be furnished in connection with the returns of taxpayers claiming depletion or depreciation must be under oath and may be included in a single affidavit. (Art. 217.)

Depletion may be deductible even if not on books.—As with depreciation, depletion charges should appear on the books and the book figures should conform exactly with those given in the returns. If it has not been the practice to record depletion, no time should be lost in making the proper book entries.

Under the 1921 law the Commissioner is authorized to require taxpayers to adhere to good accounting practice.[58] The courts may and should interpret this to mean that if depletion is not set up on the books the claim will not be allowed for income tax purposes. Moreover, the deduction claimed in the return should agree exactly with the books.

Depletion allowance to operating owner.—

REGULATION. In the case of an operating owner in fee, the amount remaining in any year returnable through depletion and depreciation deductions is (*a*) the cost or value of the property at the basic date plus (*b*) subsequent allowable capital additions and minus (*c*) depletion and depreciation sustained, whether legally allowable

[58] **[Former Procedure]** The 1918 law had a similar provision [section 212 (b)].

or not, from the basic date to the taxable year, and minus (*d*) the value of the land at the basic date for other purposes than mineral production and the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation. (Art. 202.)

Stockholder may not claim depletion.—It will be noted that a stockholder in a mining or oil or gas corporation is not entitled to any allowance for depletion, because the depletion claimed by and allowed to the corporation exhausts the allowable deduction.

REGULATION. . . . . Operating owners, lessors and lessees, whether corporations or individuals are entitled to deduct an allowance for depletion and depreciation, but a stockholder in a mining or oil or gas corporation is not allowed such deductions. . . . . (Art. 201.)

A domestic corporation owning all the stock of a foreign corporation was denied a deduction for depletion of the mine owned and operated by the foreign subsidiary.[59]

Depletion allowance to lessor.—The 1921 law[60] provides that "in the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee."

If the lessor is entitled to a sliding scale of royalties or if, as in the case of oil wells, he receives in addition to a bonus a specific part of the whole product (one-eighth of the product being a widely used figure), he will follow the same procedure as an owner who is also an operator. A member of an Indian tribe, a minor, was held to be entitled to deduct depletion from royalty receipts.[61]

When leases are for a fixed royalty per unit, appreciation in value between the making of the lease and March 1, 1913, usually accrues solely to the lessee. Appreciation which ac-

[59] C. B. I-1, page 179; A. R. M. 153.

[60] Sections 214 (a-10) and 234 (a-9). The 1918 law included the same provision.

[61] I-43-560; I. T. 1478. See also C. B. I-1, page 64; L. O. 1098.

crued prior to the making of the lease which was in effect at March 1, 1913, inures to the benefit of the lessor in apportioning the depletion allowance between lessor and lessee.

The lessor having divested himself of any return beyond the royalties, cannot participate in appreciation as such. If interest rates were lower at March 1, 1913, than when the leases were made, the lessor might claim an increased value for the property, *subject to the lease.* Revaluations as of March 1, 1913, may be placed on the books.

In all cases the lessor merely gets back through depletion his capital investment or value at March 1, 1913, and the lessee through depletion charges gets back his investment or value at March 1, 1913; and in no case must the aggregate depletion charges allowed to lessor and lessee exceed the aggregate capital investment, or the value of the property at the basic date.

Regulation. (*a*) In the case of a lessoı, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value of his equity in the property at the basic date minus (2) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, plus (3) subsequent allowable capital additions, and minus (4) the value of the land at the basic date for other purposes than mineral production and the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation.

(*b*) The value of the equities of lessor and lessee shall be computed separately, but, when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple.

(*c*) The value of the lessor's equity in the case of a mineral property not under lease on March 1, 1913, but subsequently leased, is the en bloc value of the mineral in the ground on March 1, 1913, and will, in the absence of satisfactory evidence to the contrary, be presumed not to exceed the value as of March 1, 1913, of the royalties to be expected under the lease.

(*d*) The value of a lessor's equity in a mineral property under lease March 1, 1913, for the entire operating life of the mineral deposits is the value as of March 1, 1913, of the royalties and other payments to be expected under the terms of the lease in effect on that date.

(*e*) The value of a lessor's equity in a mineral property under lease for a portion of its operating life is the value as of March 1, 1913, of the royalties expected from the mineral to be extracted during the life of the existing lease plus the estimated en bloc value of the mineral remaining at its expiration, which, in the absence of satisfactory evidence to the contrary, will be presumed not to exceed the value as of March 1, 1913, of royalties which could have been expected as at that date from the remaining mineral.

(*f*) The value of a lessor's equity in a mineral property when acquired on or after March 1, 1913, is its cost.

(*g*) The value of a lessor's equity in a discovery on or after March 1, 1913, is the fair market value at the date of discovery, or within thirty days thereafter, of his equity in the mineral discovered.[62] (Art. 204.)

The application of the principle laid down in paragraph (e) in the foregoing regulation, as affected by the 1916 law, is stated in the following:

Ruling. The question is raised as to the proper construction to be placed upon Solicitor's Memorandum 1365 in so far as it relates to the computation of deductions for depletion of a mine allowed to a lessor. . . . .

The inquiry is made in connection with the following statement of facts: A leases a property to B in 1910 at 20 cents a ton for the period of 10 years. In 1913 it is determined that the property is very valuable, and has a large tonnage of ore which will extend its life, at the probable rate of extraction, until 1940. In 1920 A renews the lease to B for the life of the mine at a royalty of $1.00 per ton. . . . .

In the case now presented the value of A's interest as of March 1, 1913, in the ore in the mine was the present worth as of that date of his royalties of 20 cents per ton, obtained by multiplying the royalty per ton by the number of tons probable extraction by the lessee and discounting the product for the remaining life of the lease, plus the value of the ore which would be left in the mine at the termination of the lease. The fair market value of the ore in the mine as of March 1, 1913, having been determined, "a reasonable allowance" to the lessor for depletion under such lease was the then present worth of his royalties, provided this did not exceed such fair market value. Upon the renewal of the lease in 1920 for the remaining life of the mine the lessor's interest in the capital sum will again be represented by the royalties stipulated to be paid, capitalized and discounted as above, and this present worth divided by the estimated

[62] [Former Procedure] Article 202, Reg. 45, before amendment in 1920 erroneously provided that a lessor could not claim any part of discovery value. See *Income Tax Procedure*, 1920, pages 771-772. (See also C. B. 3, page 175; T. D. 3089.)

mineral content of the mine at the date of the lease will equal the unit of depletion which, multiplied by the number of tons extracted in any year, will give the allowable deduction for depletion for such year, provided always that such deduction does not exceed the value as of March 1, 1913, of the ore extracted during the year. . . . . (C. B. 4, page 195; Sol. Op. 80.)

Assume that the mine leased in 1910 contained at March 1, 1913, 2,700,000 tons, annual production 100,000 tons, so that when the lease terminated in 1920, at the end of seven years, 2,000,000 tons would be left. The lessor then renews the lease at $1 royalty per ton. The Treasury says, in effect, that, since under the 1916 law the depletion deduction in any one year is limited to the "market value in the mine" of the ore removed, such market value was the present worth in 1913 of the 20-cent royalty fixed in 1910. Permission to recover any additional part of the value of the mine at March 1, 1913, (under the 1916 law) would not be granted until the termination of the lease in 1920, under which stipulated royalties of 20 cents were paid.[63]

In valuing his equity at March 1, 1913, the lessor is justified in assuming that at the end of the lease not then terminated new rates will be effective and that the new rates will be as much higher relatively as the March 1, 1913, rates exceed the rates in existing leases.[64]

Bonus in addition to royalties.—

Regulation. (*a*) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the amount remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the amount remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the amount remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received to the extent that such deductions are

[63] For detailed illustration of depletion allowance based on royalties, see *Income Tax Procedure,* 1922, pages 1220-1221.

[64] R. V. Norris, discussion of L. C. Graton's paper, *Federal Taxation of Mines,* page 43.

legally allowable. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition. . . . . (Art. 215.)

In a recent case one of the questions as to bonuses was: When annual payments of large amounts in addition to stipulated royalties were made, could the receipt of such payments be considered by the lessor as bonuses?

RULING. . . . . Upon first reading, it would appear that the above-quoted article[65] is controlling of the questions presented by this case. A careful examination discloses, however, that the term "other sum" means a sum of money in the nature of a bonus which is paid for the delivery or assignment of a lease and does not relate to rental payments which are made for the purpose of continuing the occupation and use of property. . . . . (C. B. I-1, page 186; A. R. M. 148.)

In the same ruling the other question involved was whether the property leased, and for which bonus was received by the lessor, had value at March 1, 1913, against which to apply the bonus payment. It was held that the property had no value for mineral purposes at March 1, 1913, and thus there was no capital to be recovered through depletion.

The ruling states that the property "has no value today." The lessees paid a considerable sum, apparently for the opportunity to explore the property, which must have seemed valuable to them. Similarly, at March 1, 1913, other persons may have considered the property to have prospective value. One of the tests is what a prospective lessee would pay.

APPORTIONMENT OF DEPLETION BETWEEN LESSOR AND LESSEE.—A well-known authority recommends valuing the interests of lessor and lessee separately instead of attempting an apportionment.[66]

Depletion allowance to lessee.—The 1921 and 1918 laws fully recognize that leases are property and may be revalued as of March 1, 1913, such value to be returned to the lessee

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[65] Art. 215 (a).
[66] R. V. Norris, *The Taxation of Income from Wasting Assets.*

through depletion charges without any tax being levied. This point is settled by the specific provision that "the taxpayer's interest" in "the fair market value of the property" acquired prior to March 1, 1913, is the basis of the deductions permitted. In the opinion of the author lessees have always had the same rights and privileges, in regard to depletion, as were accorded to owners under the 1913 and 1916 laws.[67]

In a recent Treasury decision[68] it is held that *depreciation* of leaseholds based on appreciated values at March 1, 1913, will not be allowed. The author does not believe that the decision is a proper interpretation of the law.

REGULATION. (*a*) In the case of a lessee, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions but minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year and the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation.

(*b*) The value of the equities of lessor and lessee shall be computed separately, but, when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple.

(*c*) The value of a lessee's equity, if acquired prior to March 1, 1913, is the value of his interest in the mineral as of that date.

(*d*) The value of a lessee's equity in a proven mineral property acquired on or after March 1, 1913, is its cost.

(*e*) The value of a lessee's equity in a discovery on or after March 1, 1913, is the fair market value at date of discovery or within thirty days thereafter, of his equity in the mineral discovered. (Art. 203.)

Prior to the issuance on September 4, 1922, of L. O. 1103 (see page 1163), the Treasury held that under the 1916 and 1917 laws lessees were not permitted to deduct depletion on appreciated March 1, 1913, value.

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[67] For former procedure and criticism of regulations and rulings, see *Income Tax Procedure*, 1918, pages 409-410, *Income Tax Procedure*, 1919, pages 611-613, and *Income Tax Procedure*, 1922, pages 1224-1226.

[68] T. D. 3414, November 25, 1922. For text of decision see page 1043.

Lessees of oil and gas properties may deduct depletion of appreciation.—During 1922 the Treasury held[69] that under the 1916 and 1917 laws depletion should be allowed to lessees of oil and gas properties because oil and gas on account of their mobility are essentially different from ore in place. Article 170, Regulations 33 (revised), was accordingly amended by T. D. 3386, issued August 22, 1922. Claims for refund for 1917 taxes overpaid in such cases should be filed before April 1, 1923.

Lessees of mines not allowed to set up appreciation at March 1, 1913.—In Law Opinion 1103 the basis of depletion under the 1916 and 1917 laws to lessees of mines is stated as follows:

Ruling. A distinction between fee owners and lessees in the case of leases of solid minerals was made in *United States v. Biwabik Mining Co.* (247 U. S., 116) and *Weiss v. Mohawk Mining Co.* (264 Fed., 502), certiorari denied (41 Sup. Ct., 12). The former arose under the Corporation Excise Tax Act of 1909, which contained no provision for depletion, but the latter arose under the Revenue Act of 1916, and held that a lessee under an ore lease is not entitled to a deduction for depletion based upon the value of its lease as of March 1, 1913. In both cases it was held that such a lessee is not the owner of the ore in place. Unless there is a distinction between oil and gas and the law applicable thereto, and solid minerals and the law applicable thereto, it must be held that these cases control the present question and justify the distinction made in Regulations 33 between fee owners and lessees in the case of oil and gas leases. . . . .

In discussing the *Weiss* case last year,[70] the author said: "The special circumstances of the case seem to have been a factor in the decision." The author believes that the matter is not yet settled by the Supreme Court of the United States. A recent decision permits a depletion deduction to a lessee of mining property, under the 1917 law, based on the value of its "property interest" therein.[71]

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[69] I-36-487; L. O. 1103.

[70] *Income Tax Procedure*, 1922, page 1226.

[71] *Alworth-Stephens Co. v. Lynch*, 278 Fed. 959 (U. S. Dist. Ct. for Minn., decided March 30, 1922).

Decision. (Syl.) Where a corporation, which had leased mining properties, agreeing to pay the owners a stipulated royalty, leased the properties to others after ore was discovered thereon, reserving a greater royalty, and, before 1913, the ore in the properties had been entirely uncovered ready for mining by the steam shovel method, so that the quantity could be ascertained with substantial accuracy, and it was obvious that the ore would be exhausted in seven years, if mined at the rate required by the lease, the corporation is entitled to deduct from the royalties received during the year 1917, in figuring its net income and excess profits tax, a depletion to the extent of the market value in the mine of the product thereof mined and paid for during the year, figured on a risk rate basis, which was found to be an average of 9 per cent.

The court stated the method of determining the "property interest" of the lessee as follows:

. . . . That the plaintiff from the year 1908 to and including the year 1917 was the owner through said leases of a property interest in said Perkins mine, and from the year 1909 to and including the year 1917 was the owner of a property interest in said Hudson mine. That on March 1, 1913, and ever since said date, to and including the whole of the year 1917, the fair market value of the ore in each of said mines, and the fair market value in the mine of the products thereof, and of each ton therein, was considerably upwards of 75 cents per ton, and that the fair market value on March 1, 1913, of the plaintiff's property interest in the ore in said Perkins mine was not less than 32.355 cents per ton, and of the plaintiff's property interest in the ore in said Hudson mine was not less than 21.57 cents per ton, in each case for each and every ton therein, and which was thereafter removed and paid for; the said fair market value of plaintiff's property interest in said ore in said mines on March 1, 1913, being ascertained by multiplying the total number of tons in the Perkins mine by the net royalty of 45 cents per ton, and the total number of tons in the Hudson mine by 30 cents per ton, to be received by the plaintiff, and considering the same as payable in equal annual installments for 7 years from March 1, 1913, and reducing the total amount so to be received to the present worth as of March 1, 1913, on a 9 per cent discount basis, and then dividing said total March 1, 1913, value by the number of tons therein and so to be mined and paid for, which gives said amount of 32.355 cents per ton for each and every ton in said Perkins mine, and 21.57 cents per ton for each and every one in said Hudson mine. That inasmuch as the life of each of said mines, or period within which each was to be exhausted and the ore mined and paid for, was not more than 7 years from March 1, 1913, and as the ore was to be mined and paid for quarterly in equal annual installments during said period, it follows that the March

1, 1913, value of each dollar which the plaintiff would receive during the life of said mines for its net property interest was 71.9 cents, and that the March 1, 1913, value of the plaintiff's property interests in each of said mines was 71.9 per cent of the total royalties that it would receive, and was 71.9 per cent of the royalty which it would receive on each ton therein when mined, removed, and paid for.

In view of the possibility of the foregoing decision being affirmed by the Supreme Court, claims for refund covering 1917 taxes overpaid should be filed before the five-year limitation period ends, i.e., before April 1, 1923.

Bonus deductible by lessee through depletion.—Depletion of capital invested in bonuses is allowed lessees.[72]

Lease as distinguished from sale.—Mining "leases" sometimes partake of the nature of a sale of the ore in place, and before determining the depletion deduction it may be necessary to ascertain whether or not the contract constitutes one a lessee. In the ruling just cited (Solicitor's Opinion 86) the Solicitor, referring to the option to purchase or so-called "bond and lease," quotes:[73]

It is often difficult in a given instance to find a technically correct legal name for the contract employed, for it may possess some of the characteristics of two or more well-defined classes. What is more important, however, from a practical standpoint is to ascertain from the contract what are the respective rights of the contracting parties.

In another case involving the construction of timber contracts, the Treasury ruled that the contracts conveying title to timber cut and removed from the property constituted leases and not sales of the standing timber.[74]

The Treasury has recently taken the position that form should be disregarded and the substance of a transaction should control its taxable status. In the case of a lease of real property which was held to be a de facto sale, the Solicitor held: ". . . . in deciding whether the transaction (a lease)

[72] C. B. 4, page 138; Sol. Op. 86.
[73] *Lindlay on Mines,* sections 859 (a) and 861.
[74] C. B. 4, page 201; A. R. M. 111.

was a sale it is immaterial that legal title did not presently pass" (I-47-600; A. R. M. 189) and the Solicitor quotes from another ruling (C. B. 2, page 84; L. O. 988): ". . . . the postponement of transfer of a legal title is not decisive. Usually when the vendee is put in possession and clothed with all the benefits and burdens of beneficial ownership, the sale will be considered complete."

The responsible lessee of mining property, who agrees under the lease to extract all of the mineral, is "put in possession and clothed with all the benefits and burdens of beneficial ownership." The deprivation of depletion based on March 1, 1913, value, when lessees bear the burdens of beneficial ownership, is not justified under the Solicitor's recent rulings.

Depletion sustained but not allowed under previous laws.—As heretofore stated,[75] the income tax laws of 1913 and 1916 imposed limitations upon the deduction for depletion.

The ruling of the Treasury,[76] that depletion sustained but not allowed under prior acts must be deducted from capital to be recovered, has not been sustained by the courts and good authorities doubt if it will be sustained. It is argued that the 1918 law requires that the capital to be returned free of tax is cost or value March 1, 1913, and that the depletion which was not deductible cannot be considered, otherwise part of the cost or value March 1, 1913, will be taxed.[77]

Development costs.—Development costs, as heretofore, may be added to capital investment and charged off thereafter as a part of depreciation or depletion, or if the items can be held to be proper operating costs they may be omitted from the annual deduction and charged direct to maintenance.

For the purposes of depletion there may be added to the cost of the fee or the lease, in the case of both owner and

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[75] See page 1112, footnote 1.
[76] C. B. 1, page 141; T. B. R. 4.
[77] *Cf.* C. B. 3, page 46; O. D. 600.

lessee, "the cost of subsequent improvements and development not charged to current operating expenses."

Oil and gas operators (as distinguished from mines) have the option of charging as expense or of capitalizing major items, such as cost of drilling wells.[78]

Depletion basis for discoverers.—The 1921 law continues the provision first found in the 1918 law which, in effect, permits the original discoverer of a mine or an oil well to set up, the market value of a new discovery as a basis for depletion charges, when the discovery is after March 1, 1913, irrespective of cost, provided the cost is materially disproportionate to the value.[79]

It has been assumed by some that the statement in the law, to the effect that as to all discoveries on and after March 1, 1913, the discoverer shall get back the market value through depletion, justifies amended returns for prior years so that the depletion charge shall commence in the year of discovery. The author does not interpret the law so. There is no doubt about the right of a discoverer to charge depletion on the basis of value instead of cost, but it was hardly the intention of Congress to permit the increased depletion charge before January 1, 1918.

There is no doubt, however, of the right to revalue at any time after March 1, 1913. If a taxpayer paid $1,000 for unproven acreage in 1915, and discovered oil thereon worth $1,000,000, he would be entitled to charge depletion up to January 1, 1918, on only the $1,000. Commencing January 1, 1918, he could charge depletion on the $1,000,000 revaluation.[80]

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[78] See page 1049.

[79] Sections 214 (a-10) and 234 (a-9). For mines, see page 1132. For oil and gas wells, see page 1146.

[80] **[Former Procedure]** While depletion *deductions* from income for the years prior to 1918 were to be based on cost ($1,000), the depletion *sustained* from date of discovery (1915) was to be computed on the basis of the discovery value ($1,000,000). The depletion not allowed as a deduction prior to 1918 represented realized appreciation. Not having been charged against income, it would have been reflected in surplus. After January 1,

Reserve for depletion of discovery value.—Section 234 (a-9) limits the depletion deduction based on discovery value (except to the extent that it is based on cost or value at March 1, 1913) to an amount not exceeding the net income from the property. This is in accord with section 204, which provides for carrying forward net losses and does not permit the taxpayer to carry forward as a net loss that portion of the depletion deduction based on the excess of the discovery value over cost or March 1, 1913, value.

The question has been raised in view of this, whether reserve for depletion should be credited with the actual depletion based on discovery value, or whether the annual credit should be limited to the amount allowed for tax purposes. The entire amount of depletion allowance for the year should be credited to the reserve, because the maximum allowance is the actual depletion. When the depletion reserve equals the discovery value (the capital sum), no further charges for depletion may be claimed.

Advance royalties and bonuses—depletion basis.—Leases of mineral lands frequently provide that minimum royalties must be paid in advance, irrespective of mining operations. The question arises whether a lessor should be entitled to claim an allowance for depletion as directly chargeable against the royalty receipts, or whether he should be entitled to the deduction only if and when it can be shown that the number of units for which a deduction is claimed have been removed from the ground. If the lessee fails to remove the stipulated quantity within the period mentioned in the lease or for other causes, the lessor may repossess the property. In such case he will find himself in the embarrassing position of having claimed a deduction covering the removal of a given number of units, whereas his property is intact or a less quantity has

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1918, the depletion based on the excess of discovery value over cost, representing appreciation realized, was likewise to be included in invested capital. See *Excess Profits Tax Procedure*, 1921, page 239.

been extracted than has been claimed. So much for the government's side.

If the lessor receives advance royalty payments during one period, and cannot claim an allowance for depletion until some subsequent period when proof can be offered to support the claim, it may be that the tax on the royalties reported as gross income will be at a higher rate than when the deduction is permitted. Or it may be that in the subsequent period the receipts will be small and the allowable deductions larger than the gross receipts. The matter is important if graduated tax rates are involved. So much for the taxpayer's side.

Restoration of bonus written off.—

Regulation. . . . . (*d*) Upon the expiration, termination or abandonment of a lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account so much of the bonus received and deducted from the amount returnable through depletion as is in excess of the actual depletion or loss in value sustained as a result of the operations under the lease and the corresponding amount will be income for the year in which the lease expires, terminates, or is abandoned. (Art. 215.)

Under the regulations owners in receipt of royalties must report royalties as taxable income but are permitted to deduct depletion even though there has been no extraction during the taxable year. It is, however, provided that if the deductions are found to be unwarranted because the minerals have not really been taken out, upon repossession the amount theretofore claimed for depletion must be returned as income for the year when the property is repossessed. The actual effect of this might be the imposition of an extremely large tax for one year.

A taxpayer leased ore deposits and received minimum royalties. In the original returns for 1916 and 1917, depletion was claimed although no ore was extracted then or later. The lease was surrendered in 1917. The Income Tax Unit held (in accordance with the regulations) that all depletion theretofore claimed became taxable income in 1917. The

taxpayer filed amended returns for 1916 and 1917 excluding depletion. The Committee on Appeals and Review held[81] that the amended returns should be accepted, basing its ruling on Law Opinion 718 (not published), which held that, "under the Revenue Act of 1917, a taxpayer who received during 1917 advance royalties on coal to apply against future mining operations was not entitled to a depletion deduction from income because no coal had been extracted."

It is rather remarkable that a law opinion rendered prior to 1919 should be used to set aside one of the 1921 regulations. The ruling, however, is equitable as the regulation would have imposed a wholly excessive tax in 1917. As suggested by the author in the 1922 edition of this book, the regulation itself should be modified. At the same time provision should be made to prevent excessive tax in one year through the inclusion of gross royalties in taxable income. There is a conditional liability arising out of future extraction which should be considered.

Dividends declared out of depletion reserves.—Certain mining companies have paid dividends which were stated to have been declared out of depletion reserves instead of earned surplus. For a discussion of this practice, see page 731 *et seq.*

Depletion basis when resources are unworkable within reasonable period.—The usual rule is that depletion charges represent the book value of the quantity mined at the per unit value, established by dividing the cost or the value at the basic date, by the entire estimated contents of the mine. This rule works well in all cases when the life of a mine is short. In practice it works well also when the life of a mine is not short, because it is not customary to include in the aggregate contents of a mine the ore or coal which cannot be mined within a reasonable time. Otherwise the owner of a mine would

[81] I-43-561; A. R. R. 1147.

receive credit for an insufficient depletion charge during the early years of operation.

The reason for this is that, in effect, nothing is paid for the ore or coal in the ground which cannot be reached by ordinary mining methods within a reasonable number of years. If the regulations were literally followed it would result inequitably and would not return the capital of the owner or lessor as the law provides.

A copper or anthracite mine might have an estimated life of 100 years, but no sane purchaser would tie up any of his capital for 100 years. The fair market value of mining property is based on the possible (or probable) extraction of the mineral content during, say, 20 or 30 years or more, depending on the circumstances of each case; and this aggregate quantity if determined by careful estimates is the proper amount by which the cost or value of the mine should be divided to ascertain the per unit cost for depletion purposes. Engineers who have given much thought to this subject suggest that the *maximum* be 45 years but in practice the maximum is more often fixed at 40 years.

Appraisals of oil and gas wells in the United States at the present time rarely show a maximum life of more than 20 years.

If all future and prospective extraction were to be considered as an element of the calculation it would be necessary to include as a factor the question of interest on capital. In other words, if the entire possible contents of a mine were to be used as a divisor it would be necessary to compute the depletion charge on a sliding scale. The total contents of a mine might be estimated at 1,000,000 tons. If the cost or value at March 1, 1913, was $100,000, the theoretical depletion charge would be 10 cents a ton; but if part of the contents could not be extracted for 50 years it would be evident that the purchaser did not pay 10 cents a ton for that part of the contents which would not be mined for 40 or 50 years. The capital invested was intended to cover only

the extraction during a period which warranted an investment.

If the capital were spread over a period longer than 20 or 30 years, the owner would expect in some way to be recompensed for the use of long time capital investment through the equivalent of an interest return.

The simplest method of handling a case of this sort would be to segregate any part of the estimated contents not removable within a profitable period, and, if it represented any capital investment, such part of the asset should be carried to a separate account designated as investment not subject to depletion. If that part of the property was opened subsequently, depletion charges would commence as if it were a new property. The investment in the mine which the owner knows will be operated and expects to have repaid through depletion charges would then appear at cost or value at the basic date; and the resulting book value of the investment divided by the quantity removable within a reasonable time would give the unit value for depletion purposes.

It might be urged that at the end of each year a certain quantity of mineral would have been extracted, but that its place would be taken, in effect, by an equal quantity which at the end of the year would have in point of time been moved forward from just outside the period to just inside the period. So that year by year the depletion would be made good by other mineral covered by the original purchase. If this line of reasoning were sound no depletion would be allowed. But the reasoning is not sound.

In most cases in which the extent of the deposits is known at the time of purchase there is a definite distinction drawn as to the value after a certain number of years, and there is the expectation that the cost of mining after a certain period will be too great to meet the competition of more favorably situated deposits. In such cases the postponement of the depletion charge would be unfair. If the later costs of mining, due to the depth of the deposit, for instance, were

far greater than the earlier costs, it is conceivable that there would be no margin to cover depletion high enough in the aggregate to return the entire capital invested.

The court decisions establish the principle that the capital invested in specific property represents the amount which must be returned to the taxpayer free of the tax. Therefore, if it is shown that at the time of purchase there was a specific amount of capital invested in a specific tonnage, the purchaser will be entitled to a return of such investment in the way of depletion charges, irrespective of additional tonnage which at the beginning may have been undeveloped and in effect is not reflected in any capital investment whatever.

Furthermore the quantity of mineral to be extracted after, say, thirty to forty years is always uncertain. If additional quantity becomes valuable or realizable while the quantity workable within a reasonable period is being extracted it is in effect appreciation and is not taxable until actually realized. Then, too, when it is realized the entire net recovery will be taxable as the book investment will have been written off.

Appreciation in land values is not allowed to offset depreciation in the value of buildings. (See page 1008.)

Depletion deductions in reorganizations.—When a reorganization is held to be in substance a mere continuance of an existing entity, involving no substantial change in interest and no realization of taxable income, there should be no recognition—for tax purposes—of appreciated values. It is claimed that the law permits a new corporation to fix its values for depletion purposes upon market values at date of organization.[82] Such a basis was equitable when the higher

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[82] **[Former Procedure]**

Ruling. A corporation which acquired in 1917 the assets of a partnership by issuing to the members of the partnership as stockholders its capital stock in the same proportion as their interests in the partnership based upon the value of the oil properties at the date of acquisition, may take a depletion deduction for the year 1918 on the basis of the known value at the date of acquisition by the corporation of such properties, the values

or appreciated values were used as a basis for the imposition of taxes. It is not equitable when the interests of the old owners in the reorganized entity are assumed to be the same as in the old property.

See comments on basis of depreciation, page 1013.

Timber-Forest Industries

While the principles underlying the valuation of timber and the computation of the allowance for its depletion are in general the same as for mines and for oil and gas wells, there is a very important difference in that the "discovery value" provision[83] of sections 214 (a-10) and 234 (a-9) does not apply to timber. There are, of course, other differences in the details of the computations because of the different physical characteristics of timber as compared with minerals.

Some of the particular points to be considered in connection with the depletion of timber are:

1. Topography.—Whether the lands are level or rolling, dry or inundated, and similar factors bearing on the ease or difficulty of successful logging.

2. Accessibility.—This involves railroad facilities and water transportation, or both. Every point under this head needs careful review, since in some operations this has determined whether or not an operating profit could be made.

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of which were discovered by the members of the partnership prior to incorporation. (C. B. I-1, page 183; Digest A. R. R. 712.)

The foregoing ruling, made under the 1918 law, is based on the separate entity theory of the Treasury. No doubt the members of the partnership were held to have realized net gains equal to the difference between the original cost of the property in 1915 and its market value in 1917, when transferred to the corporation. If it had been held that the formation of the corporation in 1917 was a continuing and not a closed transaction, and that no gain arose from the revaluation of the assets, it is doubtful if the courts would permit depletion on what under the circumstances would merely be written-up book values.

[83] See pages 1132 and 1146.

3. Blocking up.—A number of scattered tracts may have little value by themselves, but when united with others to make a block which can be profitably operated they may become very valuable. It is estimated that before building a large mill a 20 years' supply of timber should be available for it.[84] The cost of constructing saw mills, planers, dry kilns, mill ponds, logging railroads and equipping them is beyond the means of the small owner. His isolated timber has a low value because he cannot exploit it. On the other hand, the large manufacturer is not warranted in investing in expensive plant unless he has available an ample amount of stumpage. As a result, blocking up is essential and the blocked-up holding represents a far greater value because it then is susceptible of exploitation.

4. Quality of timber.—When there are a number of different species varying considerably in price, they may be divided into general classes, such as hardwoods and softwoods, or the particular species may be set up. Usually an average rate can be worked out on the basis of the cruises nearest the date of valuation, since the book records in most cases do not show the cuttings classified as to species.

5. Estimates of quantities.—Many of the problems in timber valuation have to do with the valuation as at March 1, 1913. The farther we get away from that date, the more readily should estimates as of that date be verified. That is, where the tracts under consideration have been cut since March 1, 1913, the cutting records should supply the information. These added to the quantity now estimated to be on hand will give the quantity at March 1, 1913.

Form T requires a statement of the log scale used in estimating timber. Numerous companies use the Doyle scale and others the Doyle-Scribner rule, a combination of Doyle and Scribner scales, which is said to eliminate some of the overrun. There are a variety of log scales in use and care

[84] Address by Edwin B. Parker, of the Southern Pine Association.

must be taken to make proper adjustments for any large variation between scale and actual cut.

Information is also called for as to percentage of annual growth. In tracts held for a great many years this is a factor of importance.

6. Allocation of cost or March 1, 1913, value between land and timber.—Many tracts are purchased solely for the timber. In other cases the lands, after being cut over, are valuable for agricultural purposes. If the lands have been acquired a number of years ago, all of the difficulties in attempting to translate oneself back to that time are encountered and specific evidences of value of the land, rather than general averages, are required.

After consideration of the foregoing factors, a value must be placed on the timber, if acquired prior to March 1, 1913, in the light of market conditions, as reflected by representative markets at that date, after making due allowance for cost of getting the logs to market. Inasmuch as few large tracts were sold about March 1, 1913, a comparison of sales for 3 years before and after March 1, 1913, as called for by form T, is not controlling. The peculiar circumstances surrounding each particular purchase or sale should be fully considered and the facts developed as to why it should or should not be taken as representative of the value of all the tracts on hand March 1, 1913.

In the case of mines and oil wells the Treasury discounts the operating profits from the property in arriving at the amount a prospective purchaser should pay as of date of valuation. There is authority for stating that any such procedure is not applicable to timber properties, viz., "Timber properties cannot be expected to return compound interest over long periods at the rates hitherto prevailing."[85]

[85] See "Some Public and Economic Aspects of the Lumber Industry," by William B. Greeley, *Assistant Forester Report* No. 114, Forest Service, pages 12-18, for discussion of interest rates and capitalization of stumpage values.

Maps are called for by form T, both key and detail maps. These should show clearly all of the features essential to demonstrate the bearing that the topography, accessibility, transportation facilities, blocking up, sales, purchases and other factors have on the property involved.

Regulations pertaining to forest industries are comprehensive and are reproduced hereafter in full except when the provisions are the same as for mines, etc.

The form T questionnaire (36 pages) issued by the Treasury should be in the hands of all who are interested in the valuation or taxation of forest industries.[86]

Depletion of timber.—

Regulation. A reasonable deduction from gross income for the depletion of timber and for the depreciation of improvements is permitted, based (*a*) upon cost if acquired after February 28, 1913, or (*b*) upon the fair market value as of March 1, 1913, if acquired prior thereto. The essence of this provision is that the owner of timber property, whether it be a leasehold or a freehold, shall secure through an aggregate of annual depletion and depreciation deductions a return of the amount of capital invested by him in the property, or in lieu thereof an amount equal to its fair market value as of March 1, 1913, plus in any case the subsequent cost of plant, equipment, and development which is not chargeable to current operating expenses, but not including cut-over land values. (Art. 227.)

Computation of allowance for depletion of timber.—

Regulation. The allowance for depletion of timber in any taxable year shall be based upon the number of units of timber felled during the year and the unit value of the timber in the timber account or accounts pertaining to the timber cut. The unit value of the timber for a given timber account in a given year shall be the quotient obtained by dividing (a) the total number of units of timber on hand in the given account at the beginning of the year plus the number of units acquired during the year plus (or minus) the number of units required to be added (or deducted) by way of correcting the estimate of the number of units remaining available in the account into (b) the total fair market value as of March 1, 1913, and (or) cost of the timber on hand at the beginning of the year, plus the cost of the

[86] Form T (Timber), 7 pages, is a supplementary schedule which must be filed with the return for each year subsequent to 1919, the purpose being to keep the depletion data up to date.

number of units acquired during the year, plus proper additions to capital (see art. 231). The amount of the deduction for depletion in any taxable year with respect to a given timber account shall be the product of (a) the number of units of timber cut from the given account during the year multiplied by (b) the unit value of the timber for the given account for the year. Those taxpayers who keep their accounts on a monthly basis may, at their option, keep their depletion accounts on a monthly basis, in which case the amount deductible on account of depletion for a given month will be determined in the manner outlined above for a given year. The total amount of the deduction for depletion in any taxable year shall be the sum of the amounts deductible for the several timber accounts. For description of timber accounts, see articles 235 and 236.

The depletion of timber takes place at the time the timber is felled.[87] Since, however, it is not ordinarily practicable to determine the quantity of timber immediately after felling, depletion for purposes of accounting will be treated as taking place at the time when, in the process of exploitation, the quantity of timber is first definitely determined. (Art. 229.)

In most cases tracts have been acquired both before and after March 1, 1913. This requires an allocation of the depletion charge, usually on the ratio of purchases prior and subsequent to March 1, 1913, to total holdings.[88]

Revaluation of stumpage, after March 1, 1913, not allowed.—

Regulation. In the case of timber acquired prior to March 1, 1913, the fair market value as of that date shall, when determined and approved by the Commissioner, be the basis for determining the depletion deduction for each year during the continuance of the ownership under which the fair market value of the timber was fixed, and during such ownership there shall be no redetermination of the fair market value of the timber for such purpose. However, the unit market (or cost) value of the timber will subsequently be changed if from any cause such unit market (or cost) value, if continued as a basis of depletion, shall upon evidence satisfactory to the Commissioner be found inadequate or excessive for the extinguishment of the cost, or fair market value as of March 1, 1913, of the timber. (Art. 230.)

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[87] Computing depletion on the basis of timber felled may be compared with the requirement of Art. 210, in the case of mines, that it be calculated on the number of units sold or produced.

[88] "Some Special Phases of Lumber Accounting," by Richard S. Wyler, *Journal of Accountancy*, August, 1922.

Revaluations based on discoveries after March 1, 1913, are not permitted as in the case of mines and oil wells.

CHARGES TO CAPITAL AND EXPENSE OF TIMBER PROPERTIES.—The subject of the proper division of expenditures as between capital and expense items is treated in the chapter on Depreciation, pages 1062-1064.

Evidence required to support depletion charges.—

REGULATION. To the income tax return of the taxpayer claiming a deduction for depletion or depreciation or both there shall be attached a map and statement (Form T–Timber) for the taxable year covered by the income tax return. Form T–Timber requires the following: (a) Map showing timber and land acquired, timber cut, and timber and land sold; (b) description of, cost of, and terms of purchase or lease of, timber and land acquired; (c) proof of profit or loss from sale of capital assets; (d) description of timber with respect to which claim for loss, if any, is made; (e) record of timber cut; (f) changes in each timber account as the result of purchase, sale, cutting, reestimate, or loss; (g) changes in physical property accounts as the result of additions to or deductions from capital and depreciation; (h) operation data with respect to raw and finished material handled and inventoried; (i) unit production costs; and (j) any other data which will be helpful in determining the reasonableness of the depletion and (or) depreciation deductions claimed in the return. Similar information is required for certain years prior to the 1919 taxable year from those taxpayers who have not already furnished it. The specific nature of the information required for the earlier years is given in detail in Form T—General forest industries questionnaire for the years prior to 1919. (Art. 233.)

DETERMINATION OF INTEREST OF TAXPAYER.—The law provides that the depletion is to be based on the taxpayer's interest in the property. Therefore, it is necessary to determine first what that interest is, whether owner, lessor, lessee, or whether he merely has cutting rights.[89]

Determination of fair market value of timber.—

REGULATION. Where the fair market value of the property at a specified date, in lieu of the cost thereof, is the basis for depletion

[89] C. B. 5, page 161; Sol. Op. 124.

and depreciation deductions, such value shall be determined, subject to approval or revision by the Commissioner upon audit, by the owner of the property in the light of the most reliable and accurate information available with reference to the condition of the property as it existed at that date, regardless of all subsequent changes, such as changes in surrounding circumstances, in methods of exploitation, in degree of utilization, etc. The value sought will be the selling price, assuming a transfer between a willing seller and a willing buyer as of the particular date. Such factors as the following will be given due consideration: (a) Character and quality of the timber as determined by species, age, size, condition, etc.; (b) the quantity of timber per acre, the total quantity under consideration, and the location of the timber in question with reference to other timber; (c) accessibility of the timber (location with reference to distance from a common carrier, the topography and other features of the ground upon which the timber stands and over which it must be transported in process of exploitation, the probable cost of exploitation, and the climate and the state of industrial development of the locality); and (d) the freight rates by common carrier to important markets. The timber in question will be valued on its own merits and not on the basis of general averages for regions; however, the value placed upon it, taking into consideration such factors as those mentioned above, will be consistent with that of the other timber in the region. The Commissioner will give due weight and consideration to any and all facts and evidences having a bearing on the market value, such as cost, actual sales and transfers of similar properties, the margin between the cost of production and the price realized for timber products, market value of stock or shares, royalties and rentals, value fixed by the owner for the purpose of the capital stock tax, valuation for local or State taxation, partnership accountings, records of litigation in which the value of the property has been involved, the amount at which the property may have been inventoried and/or appraised in probate or similar proceedings, disinterested appraisals by approved methods, and other factors. For depletion purposes the fair market value at a specified date shall not include any part of the value of the land. (Art. 234.)

The regulation states that the timber will be "valued on its own merits, and not on the basis of general averages for regions." In the case of some companies owning many tracts containing a variety of grades and species, and where it has been the well-settled practice for sales and purchases to be made on the basis of a general average for a particular section, the courts would probably sustain valuations made on such basis by those having experience enough to qualify as experts.

REVALUATION AFFECTING LESSEE.—

RULING. A licensee of Crown Land Limits in the Province of Quebec, Canada, is to be regarded as a lessee for tax purposes and is not entitled to deduct depletion based upon the value of the timber as of March 1, 1913. . . . . (C. B. 3, page 178; L. O. 1055.)

The leases in question, however, were terminable in one year.

For the distinction between a lease and a sale, see page 1165 *et seq.*

DETERMINATION OF QUANTITY OF TIMBER.—

REGULATION. Each taxpayer claiming or expecting to claim a deduction for depletion is required to estimate with respect to each separate timber account the total units (feet board-measure log scale, cords, or other units) of timber reasonably known or on good evidence believed to have existed on the ground on March 1, 1913, or on the date of acquisition of the property, as the case may be. This estimate shall state as nearly as possible the number of units which would have been found present by a careful estimate made on the specified date with the object of determining 100 per cent of the quantity of timber which the area would have produced on that date if all of the merchantable timber had been cut and utilized in accordance with the standards of utilization prevailing in that region at that time. If subsequently during the ownership of the taxpayer making the return, as the net result of the growth of the timber, of changes in standards of utilization, of losses not otherwise accounted for, of abandonment of timber, and/or of errors in the original estimates, there are found to remain on the ground, available for utilization, more or less units of timber than remain in the timber account or accounts, a new estimate of the recoverable units of timber (but not of the cost or the fair market value at a specified date) shall be made, and, when made, shall thereafter constitute a basis for depletion. (Art. 235.)

Timber accounts.—

REGULATION. With a view to logical and reasonable valuation of timber, the taxpayer shall include his timber in one or more accounts. In general, each such account shall include all of the taxpayer's timber which is located in one "block," a block being an operation unit which includes all of the taxpayer's timber which would logically go to a single given point of manufacture. In those cases in which the point of manufacture is at a considerable distance, or in which the logs or other products will probably be sold in a log or other market, the block may be a logging unit which includes all of the taxpayer's

timber which would logically be removed by a single logging development. In exceptional cases, provided there are good and substantial reasons, and subject to approval or revision by the Commissioner on audit, the taxpayer may divide the timber in a given block into two or more accounts, e. g., timber owned on February 28, 1913, and that purchased subsequently may be kept in separate accounts, or timber owned on February 28, 1913, and the timber purchased since that date in several distinct transactions may be kept in several distinct accounts, or individual tree species or groups of tree species may be carried in distinct accounts, or special timber products may be carried in distinct accounts, or blocks may be divided into two or more accounts based on the character of the timber and/or its accessibility, or scattered tracts may be included in separate accounts. When such a division is made, a proper portion of the total value or cost, as the case may be, shall be allocated to each account.

The timber accounts mentioned in the preceding paragraph shall not include any part of the value or cost, as the case may be, of the land. In a manner similar to that prescribed in the foregoing part of this article the land in a given "block" may be carried in a single land account or may be divided into two or more accounts on the basis of its character and/or accessibility. When such a division is made, a proper portion of the total value or cost, as the case may be, will be allocated to each account.

The total value or total cost, as the case may be, of land and timber shall be equitably allocated to the timber and land accounts, respectively.

Each of the several land and timber accounts carried on the books of the taxpayer shall be definitely described as to their location on the ground either by maps or by legal descriptions.

For good and substantial reasons to be approved by the Commissioner, or as required by the Commissioner, the timber or the land accounts may be readjusted by dividing individual accounts, by combining two or more accounts, or by dividing and recombining accounts. (Art. 236.)

Depletion and depreciation accounts on books.—Book depletion and depreciation are based on estimates of value and life. If it is known that additional tracts of timber will be acquired, the depreciation of the book value of equipment should be adjusted to the extended life. Since the requirements with respect to the accounts to be kept are practically the same as for mineral property,[90] the regulation for timber is omitted.[91]

[90] Art. 216; see page 1154.
[91] Art. 237.

CHAPTER XXXIX

DEDUCTIONS FOR CONTRIBUTIONS, DONATIONS, GIFTS AND SUBSCRIPTIONS

Individuals are permitted to deduct contributions made to certain classes of organizations up to 15 per cent of their net income. The scope of the new law was widened to include organizations not included in the 1918 law.

Partnerships may deduct from gross income such donations as are in the nature of business expenses, any others being prorated among the members and deducted in their individual returns.

Corporations have never been permitted to include gifts, as such, among their deductible expenses. There may be some merit in the argument which has been advanced that Congress did not give corporations the same status in respect to gifts which it has given to individuals because it felt it could not impliedly condone the wholesale giving away of stockholders' property by boards of directors; but the withholding from corporations of the privilege of deducting gifts does not prevent the making of so-called gifts which are deemed to be for the benefit of the business and which constitute ordinary and necessary expenses.

Gifts by individuals deductible within limitations.—

Law. Section 214. (a) That in computing net income there shall be allowed as deductions: . . . .

(11) Contributions or gifts made within the taxable year to or for the use of: (A) The United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes; (B) any corporation, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including posts of the American Legion or the Women's Auxiliary units thereof, or for the prevention of cruelty to children or animals, no part of the

net earnings of which inures to the benefit of any private stockholder or individual; or (C) the special fund for vocational rehabilitation authorized by section 7 of the Vocational Rehabilitation Act; to an amount which in all the above cases combined does not exceed 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph. In case of a nonresident alien individual this deduction shall be allowed only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States, or to such vocational rehabilitation fund. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner, with the approval of the Secretary;[1] . . . .

Gifts to United States, states, municipalities, etc., deductible.—The deduction of this type of gift was introduced for the first time in the 1921 law. The provision of the law is restrictive in the sense that contributions of such nature must be for exclusively public purposes. A taxpayer who makes a donation to the United States or a political subdivision thereof, which meets the test of being for the general good of the public, may deduct in his tax return such expenditures up to the 15 per cent limit.

The policy of permitting deductions for gifts is sound and will be of benefit to the United States and political subdivisions thereof. Ordinarily when public improvements are made under the direction of public officials, the cost thereof is assessed to taxpayers in the form of municipal taxes. Such

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[1] [Former Procedure] The 1917 law included the words "associations" and "societies" as recipients. No mention of the rehabilitation act nor of non-resident aliens was made.

No deductions for gifts were permitted before the passage of the 1917 law.

Form 1040 (revised, 1918) erroneously limited the base upon which the allowance could be computed by eliminating the amount of dividends received in 1917, applicable to earnings of prior years. Subsequently the error was discovered and corrected. (Telegram to A. Iselin & Co., from Commissioner Roper, February 27, 1918.) The author's attention has been called to the fact that many taxpayers followed the original form and failed to obtain the credit to which they were entitled. If the correction of the error has not been called to the attention of taxpayers who erroneously failed to add to the total income shown on line M of the return the dividends applicable to prior years, claim can be made for the amount of tax overpaid and refund secured, if filed within the statutory period. (See Chapter XII.)

taxes are deductible in an individual's return. If public improvements are the gift of an individual citizen they are similar in some respects to taxes, in that the public receives benefit therefrom, and it is only reasonable that a limited deduction should be permitted, as is now provided in the present tax law.

The rules prescribed by the Treasury for valuing and reporting such gifts must be adhered to.[2]

GIFT TO CITY FOR PARK PURPOSES.—

REGULATION. . . . . A gift of real estate to a city to be maintained perpetually as a public park is an allowable deduction under the present statute, but was not an allowable deduction under the Revenue Act of 1918. . . . . (Art. 251.)

Gifts to be deductible must be made to public association. —The law is not designed to cover private charity, such as assistance afforded to a needy relative or dependent; but the wording of the law is broad enough to include all contributions to churches and other recognized agencies, which in turn dispense aid to the needy.

RULING. Contributions which may be deducted in computing the net income of an individual taxpayer include not only donations to incorporated institutions, but those given to similar associations which are not incorporated. Contributions to war chest funds, war camp community funds, and similar funds which were raised solely for organizations supporting and furthering war relief, are likewise deductible items on personal returns, within the limit named in the law.

All gifts and donations to churches are deductible, it being held by the Bureau that every church constitutes a religious corporation or association for the purpose of this deduction. Donations to missionary funds, church building funds, or for church activities, which are intended for the furtherance of church work, constitute deductible items. . . . . (Statement by Bureau of Internal Revenue, February 28, 1919.)

The 1921 law specifically includes the terms "fund, or foundation," which broadens the class of organizations em-

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[2] See page 1190.

braced under this section of the law. Posts of the American Legion or Women's Auxiliary units thereof are now specifically included within this section.

The deductibility of such gifts will depend largely on the taxable status of the recipient organization. If no part of the contributed receipts inures to the benefit of any particular individual or individuals, and it can be shown that the organization comes within the contemplation of the law, the amounts donated are deductible up to the limit specified.

Many such organizations have realized that the tax laws have operated in a peculiar manner to their benefit. They are in a position to receive relatively larger amounts as gifts than the expenditure represents to the donor, the difference being the amount "saved" under this section of the law. In other words, the organization receives the tax which the government would have received had the donation not been made. This condition will continue as long as the high surtax rates are in force.

Treasury's rulings holding gifts deductible.—The Treasury has passed upon a large number of cases involving gifts. Donations to the following organizations have been held to be gifts within the 15 per cent limitation provided by section 214 (a-11) : a memorial association which is organized for the purpose of erecting by public contributions a monument and building within which will be established and maintained a museum as a depository of the records, flags, literature and trophies of the late war, as well as a forum to be utilized for educational lectures and meetings, and educational in its nature and purpose;[3] an association incorporated under the laws of Porto Rico for the purpose of soliciting and obtaining donations to be used in reconstruction work and for charitable purposes in portions of Porto Rico devastated by

[3] C. B. 3, page 188; A. R. R. 301; overruling B. 35-20-1170; O. D. 649. While this ruling appears to conflict with an earlier opinion of the Solicitor appearing in C. B. 2, page 149; S. 1246, no specific reference is made to this opinion.

earthquake and tidal wave,[4] a committee constituted by law which has control of funds to be used for the pensioning of members of a municipal police force,[5] an association organized and operated exclusively for the purpose of giving musical concerts, the programs being of an educational character and no part of the net earnings under its charter inuring to the benefit of any private stockholder or individual;[6] a board of education of a school district which has been incorporated by the laws of a state;[7] and the Council of National Defense which was established by the Army Appropriation Act of August 29, 1916.[8]

The Treasury has also held that pew rents and so-called assessments and dues paid to churches[9] and a contribution of money toward the cost of an article presented by the contributors to a corporation organized exclusively for educational purposes, are deductible.[10]

Treasury's rulings holding gifts not deductible.—Donations, however, to the following organizations have been held not to be deductible within the 15 per cent limitation provided by section 214 (a-11): a family cemetery corporation organized under the laws of the state of New York;[11] a public high school, if the funds were to be used for athletic purposes;[12] a memorial fund established, not to engage in a charitable undertaking itself, but which distributes its income to charitable institutions and to worthy individuals;[13] contributions to make good the deficit of a club engaged in recreational as well as educational activities;[14] the National Dry

[4] C. B. 1, page 151; O. D. 345.
[5] C. B. 1, page 148; S. 1202.
[6] C. B. 1, page 147; S. 1176.
[7] C. B. 1, page 146; S. 1052.
[8] C. B. 1, page 145; S. 992.
[9] C. B. 1, page 150; A. R. M. 2.
[10] C. B. 2, page 152; O. D. 465.
[11] C. B. 1, page 151; O. D. 217.
[12] C. B. 1, page 151; O. D. 126.
[13] C. B. 4, page 264; O. D. 872.
[14] C. B. 4, page 203; A. R. R. 379.

Federation;[15] an association engaged in disseminating propoganda to encourage the passage of labor legislation;[16] a company conducting a public burying ground, using its entire income for care of the cemetery.[17]

The Treasury has also held that contributions by citizens of a city to a fund raised for the purpose of inducing an industrial plant to establish itself in their city,[18] and contributions to a trust company (a corporation) in trust to invest and disburse them for a charitable purpose are not allowable deductions under section 214 (a-11).[19]

Foundations and memorials for public purposes.—The following ruling was issued in 1922 regarding the deductibility of contributions to the Woodrow Wilson Foundation. Incidentally a reference is made to the fact that contributions to the Roosevelt Memorial Association are deductible. This fact is apparently not known to some revenue agents.

Ruling. Pursuant to your request I have carefully reconsidered the question as to the deductibility under the Revenue Act of 1921, of contributions or gifts to the Woodrow Wilson Foundation. The Revenue Act of 1921 authorizes the deduction from income of contributions or gifts made to or for the use of "any corporation, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, ... no part of the net earnings of which inures to the benefit of any private stockholder or individual." The Woodrow Wilson Foundation is not a corporation and from the data submitted, it appears that no definite articles of association or by-laws have been adopted. The only activities engaged in thus far appear to be the raising of funds by a committee from the income of which it is proposed to make awards to individuals or groups rendering meritorious services along broad and rather indefinite lines. The prospectus issued by the organizers states that: "No attempt has been made at this time to settle the question of the permanent home of

[15] C. B. 1, page 150; O. D. 44.
[16] C. B. 2, page 152; S. 1362.
[17] I-37-498; A. R. R. 1122. But in a case where a city council leased a burying ground to a non-profit making company, a donation was held deductible as a gift for the use of a political sub-division of a state (C. B. I-1, page 189; I. T. 1256).
[18] C. B. 1, page 150; O. D. 39.
[19] C. B. 3, page 187; O. D. 669.

the Foundation, specific kinds of public service to be awarded or other matters concerning its future course. The present organization has considered its task to be the creation of the Foundation through the widespread support of the nation, leaving the board of trustees to determine the policies with which they will be vitally concerned." In practically identical circumstances the Bureau of Internal Revenue in 1919 ruled that contributions to the Roosevelt Memorial Association, at that time un-incorporated, and composed of a committee constituted to raise funds, were not deductible. The association was thereafter incorporated by an Act of Congress drafted specifically to meet the requirements of the income tax law, and the Bureau held that the express Congressional declaration must govern. The National McKinley Birthplace Memorial Association was incorporated by an Act of Congress to erect and maintain a public library, relic rooms and auditorium. The facts in this case are in no respect similar to those in the Wilson Foundation.

If the Woodrow Wilson Foundation will follow the same course pursued by the Roosevelt Memorial Association it will bring itself within the statute and gifts or contributions made to it will be allowed as deductions from the income of the donors. (Memorandum for the Secretary of the Treasury, signed by D. H. Blair, Commissioner of Internal Revenue, dated May 5, 1922.)

Premiums on life insurance policy deductible as a gift—when?—

Ruling. Premiums paid on a life insurance policy are allowable deductions from gross income when the beneficiary is a charitable corporation exempt from tax, provided the beneficiary named can not be changed at the option of the insured and the sum of the annual premium plus other allowable charitable contributions does not exceed 15 per cent of the taxpayer's net income. (C. B. 1, page 151; O. D. 299.)[20]

Pledges—when deductible.—The deduction evidently is limited to contributions "made" and does not include subscriptions or promises to pay in the future. A subscription may constitute a legal liability and properly so appear among other accrued and unpaid liabilities; but a reasonable interpretation of the law seems to be that contributions which are "made" are strictly limited to those which have been paid in property, cash or notes, or other evidences of debt which the beneficiaries

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[20] See also I-39-517; I. T. 1453.

can reasonably convert into cash or hold as a suitable investment.

Procedure in reporting gifts.—

REGULATION. . . . . In connection with claims for this deduction there shall be stated on returns of income the name and address of each organization to which a gift was made and the approximate date and the amount of the gift in each case. . . . . (Art. 251.)

Under the law much is left to the good faith of the taxpayer. It is not enough, however, to make a wild guess at one's total contributions for the year. An accurate record must be kept to form a basis for the report required by the regulations. If this is done, such gifts as plate collections will be permitted.

Rule for valuing gifts.—

REGULATION. . . . . Where the gift is other than money the basis for calculation of the amount of the gift shall be the cost of the property, if acquired after February 28, 1913, or its fair market value as of March 1, 1913, if acquired prior thereto, after deducting from such cost or value the amount of depreciation sustained and allowable as a deduction in computing net income. . . . . [21] (Art. 251.)

In general, the foregoing regulation places the valuation of gifts on a proper basis. The provision regarding depreciation, however, would seem to mean that if a taxpayer donates an office building which cost $100,000 in 1916 and no depreciation has subsequently been claimed (as it could have been) and the depreciated value at date of gift is $80,000, the latter amount is to be used as a deduction. If a residence which cost $100,000

[21] [Former Procedure] In an early edition of Regulations 45, this sentence of the article read as follows:

"Where the gift is other than money, the basis for calculation of the amount of the gift shall be the fair market value of the property at the time given."

As was pointed out in the 1920 edition of this book, the foregoing ruling permitted allowable deductions in excess of an equitable allowance. For a detailed criticism of this article as it originally appeared, see *Income Tax Procedure*, 1920, pages 560-562.

in 1916 is donated, credit may be taken for $100,000, because depreciation since 1916 could not have been deducted.

Assuming that the foregoing is a correct inference, the author doubts the validity of permitting deductions exceeding in amount the value of the property donated at the date of gift.

Individual credits for partnership gifts.—Gifts, such as contributions to the Red Cross, are not deductible by corporations for either income or excess profits tax purposes.[22] In the case of the partnership, however, donations not deductible as business expenses "may be prorated among the individual members of the partnership for the purpose of their individual income tax returns, as contributions or gifts," subject to the 15 per cent limitation.[23]

Article 251 specifically provides for deduction by partners:

REGULATION. . . . . The proportionate share of contributions made by a partnership may be claimed as deductions in the personal returns of the partners to an amount which, added to the amount of such contributions made by the partner individually, is not in excess of 15 per cent of the partner's net income computed without the benefit of the deduction for such contributions; but the contributions made by the partnership shall not be deducted from its gross income in ascertaining the amount of its net income to be reported on Form 1065.[24] . . . . (Art. 251.)

The distinction between gifts and business expenses.—

SO-CALLED GIFTS OFTEN BUSINESS EXPENSES.—It has been pointed out that for the most part expenditures termed "Christ-

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[22] [Former Procedure] The author always contended that partnerships were permitted under the 1917 law to deduct contributions, since section 206 of the 1917 law provided that "there shall be allowed (a) in the case of a domestic partnership the same deductions as allowed to individuals in subdivision (a) of section 5." The deduction resulted in a considerable saving in excess profits tax. The Treasury formerly disallowed 1917 contributions by partnerships, but the author's contention has been upheld by the Committee on Appeals and Review in C. B. 5, page 274; A. R. R. 651.

[23] Letter to The Corporation Trust Company, signed by Commissioner Daniel C. Roper, and dated May 23, 1918.

[24] [Former Procedure] This article has been extended to apply to personal service corporations. (C. B. I-1, page 189; I. T. 1196).

mas gifts" are, as a matter of fact, merely remuneration to the employee and properly deductible as a business expense to the employer. The same thing may be said of many payments variously characterized as gifts, donations, gratuities,[25] subscriptions, contributions, etc. In the past little attempt has been made to distinguish one class of payment from another. Certainly most payments so designated have not been distributions of profit in the usual and accepted meaning of that term. Almost without exception such items are charged to some expense account and are treated as ordinary and necessary expenses of doing business.

The Treasury's attitude toward the question of the deductibility of such items is shown in the following regulation which is largely a repetition of earlier regulations:

REGULATION. Corporations[26] are not entitled to deduct from gross income charitable or other contributions which individuals may deduct under paragraph (11) of section 214 (a). Donations made by a corporation for purposes connected with the operation of its business, however, when limited to charitable institutions, hospitals, or

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[25] A gratuity is a free gift, voluntarily given, for which the giver receives no valuable or legal consideration. . . . . It is not a charge against profits or surplus because it is not an expense or loss incurred in the operations, transactions, management or administration of a business. The giver acquires absolutely nothing; he does not liquidate a liability. The giving of it merely causes a depletion of assets resulting from a withdrawal of undivided profits or surplus.

"Possibly under peculiar conditions the giver receives consideration in the nature of advertising. In such a case it is correct to consider the disbursement a charge against advertising, but it should not be called a gratuity." (Joseph Robinson, *Journal of Accountancy,* Vol. XXVI, page 355.

[26] [Former Procedure]

REGULATION. . . . . Expenses incurred in advertising and promoting the sale of Liberty bonds and war savings stamps over the corporation's name are deductible. . . . . (Reg. 45, Art. 562.)

RULING. Where a corporation in order to promote the sale of war savings stamps to its employees donates a thrift stamp with each war savings stamp purchased, the amount expended by the corporation in purchasing the stamps so donated is an expense incurred in advertising and promoting the sale of war savings stamps over the name of the corporation and hence deductible from gross income under the provisions of article 562 of Regulations 45. (C. B. 3, page 266; O. D. 682.)

The provision that the expenses for promoting the sale of Liberty bonds are deductible expenses was hardly in line with the Treasury's attitude in the past.

educational institutions conducted for the benefit of its employees or their dependents, are a proper deduction as ordinary and necessary expenses. Donations which legitimately represent a consideration for a benefit flowing directly to the corporation as an incident of its business are allowable deductions from gross income. For example, a street railway corporation may donate a sum of money to an organization intending to hold a convention in the city in which it operates, with the reasonable expectation that the holding of such convention will augment its income through a greater number of people using the cars. Sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses, are not deductible from gross income. (Art. 562.)

This regulation is in one particular even more rigid than those which were in force some time ago. Under it, donations to be deductible must legitimately represent expenditure for a benefit "flowing directly to the corporation." T. D. 2090, in force until 1918, used the language "flowing directly or indirectly to the corporation." The example of the street railway donation, however, indicates that the Treasury may be willing to allow deductions for expenditures made in the hope or expectation that they will cause some benefit to flow "directly to the corporation." The attitude of the Treasury in the past has seemed to exclude all expenditures which did not actually result in a "consideration moving in some form" to the corporation.[27] The distinction between an expenditure which was allowable and one which was not turned apparently on the result of such payment rather than on the intention of the payer. Business, of course, could not be conducted on these principles, because vast expenditures must often be made in the expectation that due consideration will "move" to those who pay the money—but it does not always move.

Ruling. Contributions made by a corporation to a welfare league, with the understanding that such contributions are to be used for the upkeep of hospitals and furnishing accommodations for the sick and injured of such corporation, are held to represent a consideration for a benefit flowing directly to the corporation as an incident to its

[27] T. D. 2090, December 14, 1914.

business and as such are deductible as a business expense. (C. B. I-1, page 275; I. T. 1217.)

A "bank" donated a certain amount through a chamber of commerce for the purpose of inducing a railroad company to extend its tracks into the town in which it is located. It was held that the donation does not constitute an allowable deduction because "donations of the character stated are not ordinary and necessary expenses incident to carrying on a banking business" and that there is no "consideration for a benefit flowing directly to the contributing banks."[28]

The author suggests the abandonment of all such terms as gifts, donations, subscriptions, contributions, etc., in books of account. Instead, open a new account, "Payments out of profits not deductible in income tax return." Charge to this account all items which are *actually* gifts, distributions of profit —that is, where there is no consideration moving in some form to the payer. Then in the regular expense accounts include all payments which are made in the regular order of the business for the good of business, and do not call them gifts, but describe them properly. If this is done, it is not likely that any inspector will criticize the distribution so long as it is made in good faith and without intent to evade the tax.[29]

The regulations do not permit as deductions gifts to the Red Cross,[30] Y. M. C. A., or other similar purposes.

RULING. Donations made by a corporation to a Young Men's Christian Association located on its property and operated for the benefit of the employees of such corporation are not deductible as or-

[28] C. B. I-1, page 275; I. T. 1169.

[29] [British Practice] In Great Britain "donations," technically speaking, are not deductible. But payments in the nature of donations are sometimes deductible. For instance, "where . . . . subscriptions are paid by a manufacturer to an infirmary—where any of his work people *might* be sent if injured—such subscriptions are allowable as a deduction, the payment being looked upon as a trade expense." (Murray and Carter, *A Guide to Income Tax Practice* (8th edition), page 155). When no direct benefit can be read into the subscriptions, they are regarded as disposals of profit and are not deductible.

[30] See *Income Tax Procedure,* 1920, pages 566-567; also C. B. 5, page 222; T. D. 3215.

dinary and necessary business expenses. (C. B. 5, page 222; Digest O. D. 986.)

If benefits running to the corporation can be identified with gifts such as those mentioned in the foregoing ruling, the deductions should be allowed as "necessary" expenses.

Donations by agricultural corporations to fairs, etc.—

Ruling. A corporation engaged in agricultural business cannot be allowed to make a deduction from gross income on account of donations to fairs, churches and associations, such donations being made for the purpose of obtaining and preserving the goodwill of the farmers who raise crops for it, since the amounts so expended are clearly in the nature of gratuities and are not necessary expenses of operation and maintenance, as there is no such consideration in this case as is contemplated in T. D. 2090. (Letter from Acting Commissioner of Internal Revenue, June 25, 1914.)

If followed literally, this decision would deprive some corporations of the right to claim advertising as an allowable deduction. Many public service corporations advertise to retain customers' goodwill rather than to seek new business.

Fortunately for corporations, questions as to what are and are not expenses necessary to obtain and retain the goodwill of customers will not be ultimately decided by the Commissioner of Internal Revenue but by the courts. Until such decision, corporations should continue to deduct all those expenses necessary properly to maintain their businesses. This, in the opinion of the author, is in accordance with the law and with common sense.

Gifts of merchandise.—Probably every retailer is requested to make gifts to charitable and religious organizations. Usually the solicitor is a good customer and the donation is made. The author has never heard it seriously contended that gifts of this nature were other than expenses of doing business, as, of course, they are; and they should be so treated in preparing income tax returns. The Treasury in a certain case ruled that they are not allowable deductions. Corpora-

tions, as a rule, do not make payments representing "mere gratuities," but expect and receive some consideration for expenditures of a quasi-charitable nature. As soon as the courts pass on the word "expenses" as used in the law, all items of this nature will no doubt be found to be deductible.

"Treating money" an expense, not a gift.—

Regulation. So-called "spending or treating money" actually advanced by corporations to their traveling salesmen, to be used by them as a part of the expense incident to selling the product of such corporations, is an allowable deduction in a return of income by such corporation. The deduction of such expenditures is conditioned upon a satisfactory showing that all the allowance claimed as a deduction was actually expended for and was an ordinary and usual expense incurred in selling the product or merchandise of the corporation. (Reg. 33, 1918, Art. 133.)[31]

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[31] T. D. 2090, December 14, 1914.

PART IV

SPECIAL CLASSES OF TAXPAYERS

CHAPTER XL

TAX ON UNDISTRIBUTED PROFITS OF CORPORATIONS

Until the earnings have been distributed without undue delay as dividends and, consequently, have become subject to the surtax rates in the hands of the individual stockholders, the demands of the law have not been fully met.[1]

The 1921 law contains the section quoted below designed to prevent the use of the corporate form to evade the purpose of the law.

LAW. Section 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 25 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalities, as that tax: *Provided,* That if all the stockholders or members of such corporation agree thereto, the Commissioner may, in lieu of all income, war-profits and excess-profits taxes imposed upon the corporation for the taxable year, tax the stockholders or members of such corporation upon their distributive shares in the net income of the corporation for the taxable year in the same manner as provided in subdivision (a) of section 218 in the case of members of a partnership. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the busi-

[1] [Former Procedure] The 1913, 1916 and 1918 laws attempted to solve this problem by providing for a tax on the individual shareholder, equal to that which would have been payable had the earnings been distributed. It is rumored that such taxes were imposed in a few cases, but the author has not been able to learn the details of a single case. The 1917 law provided for an additional flat rate on corporations found guilty of the practice. This provision also appears to have been inoperative. The 1921 law utilizes both methods. For a full discussion of the earlier laws see *Income Tax Procedure,* 1919, pages 617-624; 1920, pages 963-974; and 1922, pages 1259-1260.

ness, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

Accumulation of earnings to be taxable must be with purpose of evasion.—

Regulation. Section 220 of the statute applies where a corporation is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members by permitting its gains and profits to accumulate instead of being divided or distributed. Prima facie evidence of a purpose to escape the surtax exists where a corporation has practically no business except holding stocks, securities or other property and collecting the income therefrom, or where a corporation other than a mere holding company permits its gains and profits to accumulate beyond the reasonable needs of the business. The business of a corporation is not limited to that which it has previously carried on, but in general includes any line of business which it may legitimately undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to escape the surtax. When one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance the business of the first corporation. Gains and profits of the first corporation put into the second through the purchase of stock or otherwise may therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not without anything further to be regarded as employment of the income in its business. (Art 352.)

A corporation could pay off all its debts, add to its plant and inventories, maintain a reserve for further plant extensions, expand in similar ways, and retain substantial cash

working capital, without being subject to tax upon its undistributed earnings.

Accumulation of earnings to be taxable must be unreasonable in amount.—

REGULATION. An accumulation of gains and profits is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if invested in increased inventories or additions to plant reasonably needed by the business. It is properly accumulated if retained for working capital required by the business or in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. In the case of a banking institution the business of which is to receive and loan money, using capital, surplus and deposits for that purpose, undistributed income actually represented by loans or reasonably retained for future loans is not accumulated beyond the reasonable needs of the business. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business. (Art. 353.)

RULING. The question as to the unreasonable accumulation of undivided profits is one of fact to be decided upon a consideration of the volume of business done and the principles of sound business management. The fact that a corporation having capital stock of $10x$ dollars and doing an annual business in excess of $150x$ dollars has an accumulation of $55x$ dollars in undivided profits is not sufficient basis for finding that there has been an unreasonable accumulation of profits. . . . . (C. B. 1, page 182; S. 1117.)

When investment companies, such as those formed by individuals and estates, invest their surplus funds in marketable securities, such as Liberty bonds, and do not pay reasonable cash dividends, an intention to relieve stockholders from surtax may be inferred. When the investments are in the securities of closely held corporations, in real estate or other property which is not readily marketable, *and* when it is necessary similarly to reinvest the accruing surplus in the same properties, the element of evasion is palpably absent.

Section 220 of the 1921 law became effective November 23, 1921, and does not affect surplus or earnings accumulated

prior to that date. Penalty sections, unlike others, never take effect retroactively. If prior to November 23, 1921, surplus was available and was not distributed, the penalties for failure to distribute are found in the abortive provision of the 1918 law. It can hardly be held that the 1921 law has any retroactive effect. Penalty sections cannot be enforced until after due notice has been given.

In all cases where no good reason exists for the accumulation of earnings subsequent to November 23, 1921, dividends corresponding closely to the realized earnings should be declared.

It is fortunate for corporations that the word "reasonable" is in the law. A corporation may refrain from distributing its profits, even if it has no debts, if there is a reasonable present need for the profits in the business or a prospective need within the reasonably near future. Conservative corporations accumulate large cash surplus whenever a profitable year enables them to do so. The courts will not hold that distributions should be made to stockholders if the directors in good faith and after due consideration decide that the present or prospective needs of the business itself (which must be paramount) do not justify larger cash dividends than are being paid.

Stockholders of properly conducted corporations need not be any more disturbed over the present law than over its predecessors. However, if accumulated earnings remain undistributed solely to permit stockholders to escape the surtax, that purpose should be frustrated.

On October 19, 1922, Secretary of the Treasury Mellon in a letter to Representative Frear said:

> As to the question of the accumulation of surplus by the Standard Oil Company of New Jersey out of past profits, this company, I believe, had over $200,000,000 of surplus which was accumulated before the passage of the Income Tax law in 1913, and the accumulations since that time have been accretions from earnings, in addition to dividends declared from year to year; but in all of these years the

company was subject to full taxes upon its earnings—some of it under the excess profits and war taxes at the then high prevailing rates.

It is not practical in any active business to distribute all the net earnings in dividends to the stockholders, and if part of the earnings were not put back into the business there would be no progress or industrial growth. In the case of this company the Commissioner of Internal Revenue has found no evidence of the accumulation of surplus beyond the reasonable needs of the business.

I have gone into this detail as to the Standard Oil Company of New Jersey, as you make that company the example, but the same principles apply generally, and so far as this department is concerned there will be no laxity in invoking the application of Section 220 wherever there is any basis for so doing.

Investment of accumulation in obligations of the United States no bar to action.—The test of ability to distribute lies in the form of the assets. Investments in Liberty bonds, when no liabilities present or prospective exist, constitute *prima facie* evidence of ability to distribute.

Declaration of stock dividends as a means of evading section 220.—Due to the hysterical suggestions of uninformed persons an epidemic of stock dividends sprang up in the latter part of 1922. It was argued that if large surpluses invested in assets not needed in the business, were wiped out by stock dividends, the Treasury would not find any surplus to which the penalties of section 220 could be applied. The suggestion is naïve; it assumes that the Treasury will deem a stock dividend to be a distribution and will hold that there is no surplus undistributed; it ignores the Solicitor's Opinion published October 2, 1922,[2] in which he refers to the decision of the United States Supreme Court that a stock dividend is *not* a distribution.[3] A stock dividend was declared and charged on the books to surplus account, wiping out (on the books) all surplus accumulated since March 1, 1913; the corporation subsequently declared a cash dividend which it charged to the period prior to March 1, 1913. The Solicitor held that the book entry and the stock dividend could not, in view of

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[2] I-40-529; Sol. Op. 144.
[3] *Eisner v. Macomber,* 252 U. S. 189, 64 L. Ed. 521, 40 Sup. Ct. 189.

the Supreme Court's decision, be considered as effecting a distribution. As the stock dividend was *not* a distribution, all of the earnings since March 1, 1913, were undistributed and when the cash dividend was declared it was held to be applicable to the identical earnings which the corporation had endeavored to wipe off the books by the stock dividend.

So with section 220. The penalty is upon accumulation "beyond the reasonable needs of the business." It is ridiculous to argue that the declaration of a stock dividend—not a distribution—which perpetuates accumulation, will be held to free corporations from the provisions of the law.

It is not likely that section 220 will be invoked in many cases. But, in no case will a stock dividend make the slightest difference.

Retirement of preferred stock.—The retirement or purchase of preferred stock would be a proper use of surplus earnings and would not be deemed to be a method of preventing the imposition of the surtax.[4]

Reduction of common stock.—

RULING. . . . . Inasmuch as a retirement of capital stock would indicate that additional capital was not required, any retirement of common stock, leaving the surplus stand, would be regarded by this office as making the corporation one coming within the provisions of Section 220 of the Revenue Act of 1918. (C. B. 2, page 25; O. D. 360.)

The purchase of common stock for the treasury or the retirement of common stock, with a consequent reduction of the aggregate stock outstanding or a reduction of the par value of each share, cannot in itself be deemed to be a method of preventing the imposition of the surtax. But if the common

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[4] [Former Procedure] A ruling which directly related to this point was rendered under the 1916 law, as amended by the Act of October 3, 1917.

REGULATION. . . . . (a) The earnings of a corporation used to purchase preferred stock for cancellation are retained for employment in the reasonable requirements of the business, and are therefore not taxable. (T. D. 2570, November 6, 1917.)

stock were purchased *pro rata* from stockholders at a large premium, it might be held that such purchase is in effect a distribution of surplus. If the surplus earned since March 1, 1913, had not been distributed, it could scarcely be claimed that the premium paid on the common stock is a distribution of capital surplus or surplus accumulated prior to March 1, 1913.

There may be exceptional cases in which the retirement of common stock would be deemed to be *prima facie* evidence that earnings were unlawfully accumulating.

Can proceeds of sale of capital assets be reinvested without subjecting stockholders to surtax?—Article 352, quoted on page 1200, states that "a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to escape the surtax." Many corporations sell all or part of their capital assets and receive in payment cash or marketable securities. The question arises, whether or not a corporation may invest or reinvest the proceeds of sale without subjecting the corporation to the 25 per cent tax.

If a corporation is in the automobile manufacturing business or holds stocks in other corporations which are in that business and sells its manufacturing business or capital stock for cash, and soon thereafter reinvests the proceeds in other automobile stocks or resumes the manufacture of automobiles, such a transaction does not constitute a radical change of business and its stockholders could not be taxed. If the corporation sells its assets and purchases general investment securities with the proceeds, such procedure involves a radical change in the business and it would be difficult to maintain that the accumulated surplus is held for the "reasonable needs of the business."

It is contrary to ordinary commercial methods for a business corporation to transform itself into an investment corporation. When stockholders invest in manufacturing or trad-

ing corporations they hazard their money and expect returns commensurate with the risks of the business. Stock in a bank or trust company is usually looked upon as less of a risk. Purchases of one or the other are made, but the author has never heard of an original purchase of one class of stock by a purchaser who expected that the corporation would transform itself into a concern of an entirely different kind. When a corporation does transform itself, a *prima facie* case is made for the imposition of the 25 per cent tax.

If corporation sells capital assets or accumulates funds in excess of its needs, how much of surplus must be divided?— If it is obvious, or if it is admitted by a corporation, that cash or marketable securities in hand are in excess of the needs of the business, the question arises as to what part of the accumulated surplus must be distributed.

Ordinarily it cannot be assumed that the earnings of a current fiscal period can be segregated to any part of the period. Surplus earnings accumulated during the taxable year 1922, which are known to be available as soon as realization takes place, fall within the purview of the law. But the 1921 law can reach only unlawful accumulations. Surplus which originated prior to November 23, 1921, if lawfully accumulated, cannot be taxed at the 25 per cent penalty rate. If unlawfully accumulated it must be taxed, if at all, under the penalty clauses contained in the earlier laws. The Treasury held that the 1918 law did not apply to surplus accumulated prior to January 1, 1918; that if any surplus was improperly accumulated prior to that date, the laws in force during the prior period are applicable thereto. Prior to November 23, 1921, unlawful accumulations could be taxed only as if the stockholders were partners.

The attitude of the Treasury in enforcing the penalty clauses in former laws is fully set forth in one case[5] in which the Secretary of the Treasury had certified that the undis-

[5] C. B. 4, page 227; A. R. R. 475.

tributed accumulations of profits were unreasonable. Upon appeal the following opinion was handed down:

RULING. . . . . The taxpayer contends that this is not a case where section 2 (A) 2 of the 1913 Act, section (3) of the 1916 Act and section (3) of the 1916 Act as amended, and section 220 of the 1918 Act should be applied, for the reason that the M Company was not a mere holding company and did not permit its gains and profits to accumulate beyond the reasonable needs of the business.

In the ordinary and accepted sense, the term "holding company" means one which is not actively engaged in business and which does nothing but hold stock of other corporations. The M Company has been actively engaged in business since its organization and has consistently paid capital stock taxes. It is noted that the 1913 Act, quoted above, requires that the corporation must be formed for the purpose of preventing the imposition of the tax through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, or must have been *fraudulently availed of* for that purpose before the Secretary of the Treasury is authorized to make the certification which has been made in this case.

An examination of the facts leading up to the organization of this corporation, the consideration of the rate of dividends paid, and the amounts carried to surplus from year to year do not indicate to the Committee that the corporation was *fraudulently availed of* for the purpose of preventing the imposition of the tax through the medium of permitting the gains and profits to accumulate instead of dividing or distributing such gains and profits.

Therefore the Committee recommends that the action of the Income Tax Unit in assessing additional taxes for the years 1913 to 1917, inclusive, was in error and that such action be reversed and that the claim filed for the refunding of taxes paid on account of such assessment receive favorable consideration.

The Committee has accepted the Bureau's position with respect to the reasonable requirements of a business as outlined in Treasury Decision 2736. Applying the principle therein laid down to the facts in the instant case, it would appear that all the capital of the M Company which is invested in the capital stock of the N Company or which is used in making loans and otherwise financing such subsidiary *is needed in the business* of such company. The facts now submitted are materially different from those submitted to the Secretary of the Treasury at the time the certification in question was made. Upon the basis of this additional evidence the present Secretary of the Treasury signed a resolution recalling the former certification in this case. The Committee is in full accord with this action. The effect of this resolution is to remove the presumption of fraud heretofore existing against the corporation.

It is strongly urged that any taxes assessable under the provisions of the revenue Acts quoted above are in the nature of a *penalty,* and in order that such assessment may properly be made *fraud or fraudulent intent* must be established. It is submitted in the instant case that the corporation in carrying to surplus a considerable part of its earnings yearly *is doing nothing more than was contemplated under the provisions of its charter.* It is also submitted that this corporation could not have been created for the purpose of permitting its earnings to accumulate, thereby preventing the imposition of tax on such earnings, for the reason that the corporation was organized in 1898. The mere fact that the corporation carried to surplus these earnings is not to be considered as a *fraud upon the Government,* bearing in mind always that the corporation is not a mere holding company, that it has considerable income from operations, rents, royalties, and from interest on money loaned and investments in bonds. The corporation has been conservative in carrying a considerable portion of its earnings to surplus, and the mere fact that such earnings were carried to surplus and that the corporation now has a large accumulated surplus does not of itself authorize the Income Tax Unit to assess a tax against the stockholders on their pro rata share of such earnings. The fact that the corporation increased its dividends and, having increased the dividends, continued to pay same even though the earnings of the corporation fluctuated from year to year, substantiates the view of the Committee that the corporation was not fraudulently availed of for the purpose of preventing the imposition of the tax through the medium of permitting the gains and profits to accumulate instead of distributing such gains and profits. . . . . (C. B. 4, page 227; A. R. R. 475.)

Election to be taxed as individuals.—The 1921 law provides that if *all* stockholders agree, the corporation may be relieved of "all income, war-profits and excess-profits taxes" and the stockholders as individuals shall be taxed upon their distributive shares. The only apparent excuse for such an agreement would be the definite knowledge that the 25 per cent penalty tax is to be enforced. In such cases stockholders should agree. But the contingency can hardly arise in a business corporation, and if it appears to arise in other cases the proper procedure is to distribute current earnings as they accumulate.

Ruling. The books of the M Company reflect profits of approximately x dollars for the taxable year 1921. The company has actually negotiated for the purpose of certain real estate and the construction

of a building for the purpose of installing its own plant, and the 1921 profits together with an amount now held in a sinking fund will be required for the financing of these projects.

Inquiry is made whether, in view of these circumstances, the stockholders of the corporation may, under section 220 of the Revenue Act of 1921, elect to be taxed as partners, thereby avoiding the levying of any tax upon the corporation.

Section 220 of the Revenue Act of 1921 provides for a tax of 25 per cent, in addition to the ordinary income tax, upon the net income of any corporation which is availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed. There is a proviso in this section to the effect that if all the stockholders or members of "such corporations" (which must be understood to mean only a corporation formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders) agree thereto, no income, war-profits or excess-profits taxes need be assessed against the corporation, but instead thereof the stockholders may be taxed as partners upon the undistributed profits of the corporation. It is thus seen that it is permissible to tax the stockholders of a corporation as partners, leaving out of consideration personal service corporations, only when the corporation is availed of for the purpose of avoiding the imposition of surtaxes upon its members. In the present case it is clear that the corporation is not being used for this purpose. The profits are intended to be utilized for the purpose of providing its own plant for the corporation, and the corporation does not, therefore, come within the section above referred to, since the profits are being put back into the business. There is, therefore, no warrant for treating the stockholders of this corporation as partners, even though the stockholders should desire that this be done.

The M Company should therefore file its return and pay taxes as a corporation. (C. B. I-1, page 218; I. T. 1289.)

CHAPTER XLI

NON-RESIDENT ALIENS

The 1921 law[1] deals at greater length than prior laws with the determination of the gross income of non-resident aliens.

All individuals residing in the United States, whether citizens or not, and all corporations maintaining an office or place of business in the United States, whether organized under the laws of the United States (domestic corporations) or of foreign countries (foreign corporations), are subject to the income tax. The theory of tax laws is that, wherever property is found within the jurisdiction of the law (except the portion devoted to public or charitable uses), it must make a contribution to the support of the government; and all persons or corporations enjoying the benefit of the laws of the United States are called upon to pay a tax on the income which they receive under the protection of those laws. Since non-resident alien individuals and corporations are outside the jurisdiction of the United States so far as their persons are concerned, the only method by which the tax on their incomes from sources within the United States can be collected is by withholding it at the source. This chapter deals with the law and regulations which define the rates of tax, the classes of income, the exemptions and deductions allowed, and the method of collection of the tax on the incomes of non-resident aliens derived from sources within the United States.[2] It is therefore of interest particularly to two classes of persons: the non-resident alien himself who is in receipt of income from

[1] Section 217 for individuals. Section 233 (b) makes the classification in section 217 also applicable to the gross income of foreign corporations, except foreign insurance companies subject to the tax imposed by sections 243 and 246.

[2] For former procedure, see *Income Tax Procedure,* 1921, page 975 *et seq.*

United States sources, and the payer of such income, who is compelled to withhold and pay the tax thereon.

Rates of tax for non-resident alien individuals.[3]**—**

LAW. Section 210. . . . . there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 8 per centum of the amount of the net income in excess of the credits provided in section 216: . . . .

Rates of surtax.—Rates of surtax on the income of non-resident aliens are the same as in the case of citizens or residents of the United States as given in section 211. (See Chapter IX, page 168.)

Rates of tax for foreign corporations.—

LAW. Section 230. . . . . (a) For the calendar year 1921, 10 per centum of the amount of the net income in excess of the credits provided in section 236;[4] and

(b) For each calendar year thereafter, 12½ per centum of such excess amount.

Non-resident Alien Individuals

The first question which naturally arises is: Who is a non-resident alien?

REGULATION. A "nonresident alien individual" means an individual (*a*) whose residence is not within the United States and (*b*) who is not a citizen of the United States. An alien actually present in the United States who is not a mere transient or sojourner is a resident of the United States for purposes of the income tax. Whether he is a transient or not is determined by his intentions with regard to the length and nature of his stay. A mere floating intention, indefinite as to time, to return to another country is not sufficient to constitute him a transient. If he lives in the United States and has no definite intention as to his stay, he is a resident. One who comes to the United States for a definite purpose which in its nature may be promptly accomplished is a transient; but if his purpose is of such a nature that an extended stay may be necessary for its accomplishment, and to that end the alien makes his

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[3] Normal tax on the first $4,000 of net income at the rate of 4 per cent applies only to citizens and residents.

[4] Cee Chapter XV for credits enumerated under section 236.

home temporarily in the United States, he becomes a resident, though it may be his intention at all times to return to his domicile abroad when the purpose for which he came has been consummated or abandoned. . . . . (Art. 311.)

Proof of residence of alien.—

Regulation. The following rules of evidence shall govern in determining whether or not an alien within the United States has acquired residence therein within the meaning of the Revenue Act. An alien, by reason of his alienage, is presumed to be a nonresident alien. Such presumption may be overthrown (1) in the case of an alien who presents himself for determination of tax liability prior to departure for his native country, by (a) proof that the alien, at least six months prior to the date he so presents himself, has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (b) proof that the alien, at least six months prior to the date he so presents himself, has filed Form 1078 or its equivalent, or (c) proof of acts and statements of the alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States had been of such an extended nature as to constitute him a resident; (2) in other cases by (a) proof that the alien has filed a declaration of his intention to become a citizen of the United States under the naturalization laws, (b) proof that the alien has filed Form 1078 or its equivalent, or (c) proof of acts and statements of an alien showing a definite intention to acquire residence in the United States or showing that his stay in the United States has been of such an extended nature as to constitute him a resident. In any case in which an alien seeks to overcome the presumption of nonresidence under (1) (c) or (2) (c) above, if the officer who examines the alien is in doubt as to the facts, such officer may, to assist him in determining the facts, require an affidavit or affidavits setting forth the facts relied upon, executed by some credible person or persons, other than the alien and members of his family, who have known the alien at least six months prior to the date of execution of the affidavit or affidavits. (Art. 312.)

Loss of residence by alien.—

Regulation. An alien who has acquired residence in the United States retains his status as a resident until he abandons the same and actually departs from the United States. An intention to change his residence does not change his status as a resident alien to that of a nonresident alien. Thus an alien who has acquired a residence in the United States is taxable as a resident for the remainder of his stay in the United States. The status of an alien on the last day

of his taxable year or period determines his liability to tax for such year or period as a resident or nonresident. . . . . (Art. 313.)

Determination of status of alien leaving the United States. —The status of an alien leaving the United States during the taxable year is determined by his status on the last day of his taxable period.

RULING. . . . . The taxable period is the interval between January 1 and the last day of the month preceding his departure. If the alien had formed no intention of leaving the United States by such date he will be taxed as a resident alien. If, however, his intention to depart was formed prior to the last day of the month preceding departure, he will be taxed as a nonresident alien for such period. In either case the alien is entitled to the full exemption and credit for dependents that he would have been entitled to had his return been filed for the full taxable year. If the absence of a resident alien is to be only temporary, he will not lose his status as resident by reason of such absence. (C. B. 2, page 243; O. D. 468.)

ALIEN SEAMAN—WHEN TO BE REGARDED AS RESIDENT.—

REGULATION. In order to determine whether an alien seaman is a resident within the meaning of the income-tax law, it is necessary to decide whether the presumption of nonresidence is overcome by facts showing that he has established a residence in the territorial United States, which consists of the States, the District of Columbia, and the Territories of Hawaii and Alaska, and excludes other places. . . . . An alien may remain a nonresident although he is not in transit through the country. . . . . [Art. 311 (a).]

It is apparent from the foregoing regulations that residence for income tax purposes is a question both of intent and of fact. If an alien lives as long as one year within the United States, such fact is presumptive but not conclusive evidence as to residence.[5] Nevertheless, the pay-rolls of an employer may be accepted as written evidence of an employee's continuous residence in the United States, thereby establishing his status as a resident alien, unless the employer knows that the employee does not intend to remain here permanently.[6] A member of a foreign partnership who is within the territorial

[5] C. B. 1, page 164; O. D. 197.
[6] Treasury Bulletin "B," page 13.

limits of the United States seven or eight months of the year does not become a resident if his presence here is to complete business for his firm and if when that is accomplished he returns abroad.[7] A non-resident alien who has served at least one year in the United States Army has been considered a resident for income tax purposes.[8] It is necessary for a widow who was a citizen before her marriage to a non-resident alien to register as an American citizen with a United States consul within one year after the death of her husband if she would become a citizen instead of a non-resident alien for tax purposes.[9] Members of the families of foreign ambassadors and attachés, secretaries and servants included in their suites, are held to have the status of non-resident aliens for tax purposes and are subject to taxation only as to income from any business conducted by them in the United States.[10] Non-resident naturalized citizens who expatriate themselves but subsequently apply to an American consul for registration as American citizens, do not thereby become repatriated though their registration is accepted by the Department of State.[11]

The act relative to the naturalization and citizenship of married women (Public No. 346—67th Congress) should be consulted for the status of married women.

Duty of employer to determine status of alien employee.—

Regulation. If wages are paid to aliens without withholding the tax, except as permitted in article 315, the employer should be prepared to prove the status of the alien as provided in the foregoing articles. An employer may rely upon the evidence of residence afforded by the fact that an alien has filed Form 1078 or an equivalent certificate of the alien establishing residence. An employer need not secure Form 1078 from the alien if he is satisfied that the alien is a resident alien. An employer who seeks to account for failure to withhold in the past, if he had not at the time secured Form 1078 or its equivalent, is permitted to prove the former status of the alien

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[7] C. B. 3, page 128; O. D. 592.
[8] C. B. 1, page 163; O. D. 117.
[9] C. B. 2, page 59; O. D. 533.
[10] C. B. I-1, page 102; T. D. 3266.
[11] C. B. 4, page 59; O. D. 861.

by any competent evidence. The written statement of the alien employee may ordinarily be relied upon by the employer as proof that the alien is a resident of the United States. (Art. 314.)

Form 1078—"Certificate of alien claiming residence in the United States."—The presumption of non-residence is overcome by obtaining from the alien form 1078 (revised) or an equivalent certificate of alien claiming residence. Ordinarily this form should be executed before an officer duly authorized to administer oaths.

Ruling. . . . . However, if such an officer is not reasonably accessible, it will be accepted if signed in the presence of an officer of the employer company under whose supervision the employee's duties are performed, and one other credible witness. If the withholding agent did not procure this form or its equivalent, at the time of payment, he may prove the former status of the alien by any material evidence. Execution of this form does not bind the alien to become a citizen or to reside here permanently. Furthermore, it will not be necessary to procure this certificate every taxable year. It is applicable to the year during which filed and subsequent years. The employer should keep a record of each Form 1078 filed. The forms should be sent to the Commissioner of Internal Revenue, Sorting Division, Washington, D. C., not later than the 20th of the month succeeding that during which the certificate was received. (Treasury Bulletin "B," page 14.)

If form 1078 (revised) has not been secured from an alien employee and the employer is required to account for failure to withhold tax in the past, he is permitted to submit pay-roll records as written evidence or proof of the status of the employee.[12]

Resident Foreign Corporations and Partnerships

Foreign corporations and partnerships are defined as follows:

Law. Section 2. . . . . (4) The term "foreign" when applied to a corporation or partnership means created or organized outside the United States;

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[12] Treasury Bulletin "B," page 13; see also *Income Tax Procedure*, 1920, page 818.

(5) The term "United States" when used in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia. . . .

REGULATION. A domestic corporation or partnership is one organized or created in the United States, including only the States, the Territories of Alaska and Hawaii, and the District of Columbia, and a foreign corporation or partnership is one organized or created outside the United States as so defined. A domestic corporation is a resident corporation even though it does no business and owns no property in the United States. The nationality or residence of members of a partnership does not affect its status. A partnership created by articles entered into in San Francisco between residents of the United States and residents of China is a domestic partnership. A foreign corporation engaged in trade or business within the United States or having an office or place of business therein is sometimes referred to in the regulations as a resident foreign corporation and a foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein as a nonresident foreign corporation. . . . (Art. 1509.)

Taxable Income of Non-resident Aliens

The income of non-resident aliens which is considered to be income from sources within the United States and therefore taxable, may be summarized as follows:

1. Interest on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise.[13]
2. Dividends from certain domestic and foreign corporations.[14]
3. Compensation for labor or personal services performed in the United States.
4. Rentals and royalties from United States sources.
5. Gains from sale of real property located in the United States.

While the foregoing represents what is generally taxable income to a non-resident alien, there are various items not subject to tax which are specifically dealt with later in this

[13] For exceptions relative to interest, see page 1222.
[14] See page 1223.

chapter.[15] Of these exempt items, interest on deposits in banks located in the United States paid to persons not engaged in business within the United States was for the first time exempted by the 1921 law. Considerable objection had previously been raised concerning the taxation of this interest and its exemption now is as popular as it is equitable. Another new feature of the present statute is the exemption from taxation of interest received from a resident alien individual or from resident foreign corporations where less than 20 per cent of the gross income of the payer has, for the preceding three years, been derived from sources within the United States.

From the taxable items constituting the gross income there may be deducted items of expense properly allocated to such income. Where the segregation of expenses against particular gains cannot be made, a proportionate part of the total expenses must be so allocated.

When the 1921 law was being drafted, it was proposed to tax citizens or residents of the United States, domestic partnerships or domestic corporations, 80 per cent of whose gross income for the past three years was from sources without the United States, and 50 per cent of whose gross income for the past three years was from the active conduct of a business outside the United States, only on the income arising from sources within the United States as defined in section 217. However, the 1921 law as finally approved limits the privilege to citizens of the United States and to domestic corporations.[16]

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[15] See page 1239.

[16] **[Former Procedure]** RULING: A corporation organized in the United States is subject to the 4 per cent war income tax imposed by section 4 of Title I of the Revenue Act of 1917, even though it has its principal office, keeps its accounts, and does all of its business in Porto Rico and derives all of its income from sources therein. Such a corporation should file its return in the internal revenue district where its principal office in the United States is located.

Law Opinion 303 (not in bulletin service) revoked. . . . . (C. B. 4, page 259; L. O. 1066.)

Gross income defined.—The gross income of non-resident alien individuals[17] and foreign corporations[18] is covered by the following statutory provisions and regulations:

LAW. Section 213. . . . . **(c) In the case of a nonresident alien individual, gross income means only the gross income from sources within the United States, determined under the provisions of section 217.**

REGULATION. In the case of nonresident alien individuals "gross income" means only the gross income from sources within the United States, determined under the provisions of section 217. . . . . As to the gross income of foreign corporations see section 233 (b) of the statute and article 550; also section 217. . . . . The items of gross income from sources without the United States and therefore not taxable to nonresident aliens or foreign corporations are described in section 217 (c) . . . . (Art. 92.)

The essential differences between the 1921 and the 1918[19] law are contained in section 217 of the former, which is referred to in the foregoing regulation. In so far as income is concerned the material changes are the *exclusion* under specific conditions, of

1. Interest on deposits with persons carrying on a banking business.
2. Interest received from resident alien individuals or resident foreign corporations when less than 20 per

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[17] Members of foreign partnerships having an office or place of business in the United States are taxed in their individual capacity upon their respective shares of income of the partnership from sources within the United States. See T. D. 3268, quoted on page 1256, and Chapter XXIX.

[18] Under the Revenue Act of 1916 the Treasury ruled that foreign corporations, of the nature specified as being exempt from taxation, are in the tax-exempt class. There has been no subsequent ruling on this point, but the wording of the law would imply that such organizations are exempt from tax.

[19] **[Former Procedure]** The following definition of "gross income" obtained under the 1918 law:

REGULATION. In the case of nonresident alien individuals "gross income" means only the gross income from sources within the United States. This includes interest on bonds, notes or other interest-bearing obligations of residents, corporate or otherwise, dividends from resident corporations, amounts received representing profits on the manufacture or disposition of goods within the United States, rentals and royalties from property and income from business carried on in the United States, interest on deposits in banks located within the United States, income from capital otherwise invested in the United States, and income from services rendered or labor performed within the United States. . . . . (Reg. 45, 1918, Art. 91.)

cent of the gross income of the payer, for the three preceding years, has been derived from sources within the United States.

3. Dividends from corporations entitled to the benefits of section 262.
4. Earnings derived from the operation of ships under circumstances defined in section 213 (b-8).

The changes in the nature of additional *inclusions* are:

1. Dividends from foreign corporations 50 per cent or more of whose gross income for the three years preceding the declaration of such dividend was derived from sources within the United States.
2. Gains, profits and income from the sale[20] of real property located in the United States.
3. Rentals and royalties, which are extended to embrace the use of, or the privilege of using, in the United States, patents, copyrights, formulas, trademarks and other like property.

The profit derived by a non-resident alien author from the sale of all rights of serial publication in the United States in certain stories is not considered as income from a source within the United States and accordingly is not subject to withholding. (C. B. 5, page 117; O. D. 988.) See also comment on ruling I. T. 1231, page 1238.

LAW. Section 233. . . . . **(b) In the case of a foreign corporation, gross income means only gross income from sources within the United States, determined (except in the case of insurance companies subject to the tax imposed by section 243 or 246) in the manner provided in section 217.**

There is no difference in the computation of the gross income of foreign corporations and non-resident alien individuals. Both are governed by section 217 of the statute.

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[20] LAW. Section 217. . . . . (f) As used in this section the words "sale" or "sold" include "exchange" or "exchanged"; and the word "produced" includes "created," "fabricated," "manufactured," "extracted," "processed," "cured," or "aged.". . . .

REGULATION. The gross income of a foreign corporation, including a mutual insurance company, means its gross income from sources within the United States, as defined and described in section 217 and articles 316-328 relating to nonresident alien individuals. . . . . (Art. 550.)

Income of Non-resident Alien Individuals or of Citizens Entitled to Benefit of Section 262

Section 213 (c)[21] defines gross income as that determinable under section 217, which has two main divisions:

1. Income from sources within the United States, covered by subdivision (a).
2. Income from sources without the United States, covered by subdivision (c).[22]

Income from sources within the United States.—

LAW. Section 217. (a) That in the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the following items of gross income shall be treated as income from sources within the United States: . . . .

Not only does section 217 define the income of nonresident aliens which is to be treated as arising from sources within the United States, but the section is applicable also to citizens entitled to the benefits of section 262.

LAW. Section 262. (a) That in the case of citizens of the United States or domestic corporations, satisfying the following conditions, gross income means only gross income from sources within the United States—

(1) If 80 per centum or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section) for the three-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

(2) If, in the case of such corporation, 50 per centum or more of its gross income (computed without the benefit of this section) for

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[21] See page 1218.

[22] Subdivision (c) includes the same kinds of income as subdivision (a), but from sources without the United States.

such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States; or

(3) If, in the case of such citizen, 50 per centum or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another.

(b) Notwithstanding the provisions of subdivision (a) there shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.[23] . . . .

INTEREST.—

LAW. Section 217. (a) . . . . (1) Interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including (A) interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States and not having an office or place of business therein, or (B) interest received from a resident alien individual or a resident foreign corporation when it is shown to the satisfaction of the Commissioner that less than 20 per centum of the gross income of such resident payor has been derived from sources within the United States, as determined under the provisions of this section, for the three-year period ending with the close of the taxable year of such payor, or for such part of such period immediately preceding the close of such taxable year as may be applicable; . . . .

The following excerpt from the regulations covering the foregoing subsection of the law, calls attention to the necessity of the taxpayer proving that the income he reports thereunder falls within the meaning of the law.

REGULATION. There shall be included in the gross income from sources within the United States, of nonresident alien individuals, foreign corporations and citizens of the United States or domestic corporations which are entitled to the benefits of section 262, all interest received or accrued, as the case may be, on bonds, notes, or

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[23] Section 262 (b) means that if United States citizens and domestic corporations remit amounts received in United States possessions to the United States, such amounts must be included in gross income. If taxpayers have qualified under section 262 (a) and wish to omit from gross income amounts received from without the United States, it is important that such amounts also be disbursed without the United States. In order to secure the benefits of section 262, a taxpayer should submit to the Commissioner of Internal Revenue a statement of the total gross income received, both from within and without the United States.

other interest-bearing obligations of residents of the United States, whether corporate or otherwise, except:

(a) Interest paid on deposits with persons, including individuals, partnerships, or corporations carrying on the banking business, to persons (nonresident alien individuals, foreign corporations and citizens of the United States, or domestic corporations entitled to the benefits of sec. 262) not engaged in business within the United States, and not having an office or place of business therein; and

(b) Interest received from a resident alien individual or a resident foreign corporation when it is shown to the satisfaction of the Commissioner that less than 20 per cent of the gross income of such resident payor has been derived from sources within the United States for the three-year period ending with the close of the taxable year of such payor, or for such part of such period immediately preceding the close of such taxable year as may be applicable.

Any taxpayer who excludes from gross income from sources within the United States income of the type specified in (a) or (b) above shall file with his return a statement setting forth the amount of such income and such information as may be necessary to show that the income is of the type specified in those paragraphs. (Art. 317.)

Ruling. For the three-year period immediately preceding the close of the taxable year, 80 per cent of the gross income of a citizen was received in the Canal Zone for services there rendered as a member of the United States Army and for the Panama Canal. Section 262 is applicable to this case. (I-36-492; Digest I. T. 1438.)

Since corporations doing business in the United States are not exempt from tax under the provisions of section 217 (a-1), it is often necessary to determine whether a corporation is or is not doing business in the United States to ascertain its liability or non-liability to taxation.

It has been held that a foreign corporation which maintains an agent in the United States, for the purchase of materials and their shipment to the corporation, was doing business in the United States, and that consequently interest on bank accounts of the corporation in the United States was taxable income.[24]

Ruling. A remittance to a non-resident alien beneficiary (not engaged in business in the United States or having an office or place of business therein) of a distributable estate of interest on bank deposits, credited to the account of the trustee, is income from the

[24] I-31-441; I. T. 1406.

estate and not "interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States." (I-31-440; Digest I. T. 1405.)

Dividends.—

Law. Section 217. (a) . . . . (2) **The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (B) from a foreign corporation unless less than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of this section; . . . .**

Regulation. Gross income from sources within the United States includes all dividends, as defined by section 201:

(*a*) From a domestic corporation other than one entitled to the benefits of section 262; and

(*b*) From a foreign corporation unless less than 50 per cent of its gross income for the three-year period ending with the close of its taxable year preceding the declaration of such dividends or for such part of such period as it has been in existence, was derived from sources within the United States.

Dividends will be treated as income from sources within the United States unless the taxpayer submits sufficient data to establish the fact that less than 50 per cent of the gross income of the foreign payor corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividend was derived from sources within the United States. (Art. 318.)

Dividends of the classes above described are included in gross income, but as they are allowed as a credit under section 221, no tax is payable thereon.

Ruling. A corporation created and organized under special acts of Congress or under the laws of any state or Territory of the United States, although doing no business and owning no property within the United States, is a resident corporation within the meaning of the Revenue Act of 1918; accordingly, dividends on its stock and interest on its obligations, paid to non-resident alien individuals or foreign corporations, are subject to taxation as income received from sources within the United States.

Article 92, Regulations 45, 1920 edition, should be amended.

Law Opinions 397 (not published in Bulletin service) and 902 (C. B. 1, p. 100) revoked. . . . . (C. B. I-1, page 204; L. O. 1069.)

Compensation.—

Law. Section 217. (a) . . . . (3) **Compensation for labor or personal services performed in the United States; . . . .**

Regulation. Gross income from sources within the United States includes compensation for labor or personal services performed within the United States regardless of the residence of the payor, of the place in which the contract for services was made, or of the place of payment. When a specific amount is paid for labor or personal services performed in the United States, such amount shall be included in the gross income. When no accurate allocation or segregation of compensation for labor or personal services performed in the United States can be made, or when such labor or service is performed partly within and partly without the United States, the amount to be included in the gross income shall be determined by an apportionment on the time basis, i. e., there shall be included in the gross income an amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the United States bears to the total number of days of performance of labor or services for which the payment is made. (Art. 319.)

Ruling. The firm of M & Co. is a domestic partnership which earns all of its income from sources within the United States. A, one of the partners, is a non-resident alien, and performs all of his services for the firm in a foreign country. The partnership agreement provides that the partners shall receive certain specified sums as compensation for services rendered by them, which amount is to be charged as expenses before computing the net income of the partnership.

Inquiry is made whether the compensation credited to A for his services should be treated as income earned outside the United States and therefore not taxable to a non-resident alien, or whether this compensation should be treated as part of his distributive share of the net income, in which case it would be subject to the Federal income tax.

Held, that as the compensation received by A from the partnership is paid for his services rendered the partnership outside the United States, he is not liable for Federal income tax thereon.

In view of the fact that the partnership agreement provides that the compensation paid the partners for services rendered by them is to be charged as expenses and deducted from the gross income of the partnership for the purpose of computing its net income, such compensation should not be included in A's distributive share of the net profits of the partnership. This ruling is based on the assumption that the amounts paid to the members of the partnership for their services represent reasonable compensation. (I-34-466; I. T. 1425.)

It has been held that income received by a non-resident alien from the sale in the United States of newspaper articles written in this country while temporarily sojourning here is subject to taxation as income from sources within the United States.

RENTALS AND ROYALTIES.—

LAW. Section 217. (a) . . . . (4) **Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property; . . . .**

SALE OF REAL PROPERTY.—

LAW. Section 217. (a) . . . . (5) **Gains, profits, and income from the sale of real property located in the United States. . . . .**

REGULATION. . . . . (c) A nonresident alien individual, or a citizen entitled to the benefits of section 262 may elect to be taxed under section 206 with respect to sales or exchanges of property located within the United States, subject to the limitation that his total tax may not be less than 12½ per cent of his total net income from sources within the United States. (Art. 1651.)

For the treatment of capital net gain, see full discussion of the subject in Chapters XXI and XXII.

Only non-resident alien individuals are interested in whether or not profits from sale of property are to be taxed as a "capital gain," as the income and the capital gains of corporations (both foreign and domestic) are taxed at the same rate, viz., 12½ per cent.

Income from sources partly within and partly without the United States.—

LAW. Section 217. . . . . (e) **Items of gross income, expenses, losses and deductions, other than those specified in subdivisions (a) and (c), shall be allocated or apportioned to sources within or without the United States under rules and regulations prescribed by the Commissioner with the approval of the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the net income**

therefrom) the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States. In the case of gross income derived from sources partly within and partly without the United States, the net income may first be computed by deducting the expenses, losses or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which can not definitely be allocated to some item or class of gross income; and the portion of such net income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Commissioner with the approval of the Secretary. Gains, profits and income from (1) transportation or other services rendered partly within and partly without the United States, or (2) from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States, shall be treated as derived partly from sources within and partly from sources without the United States. Gains, profits and income derived from the purchase of personal property within and its sale without the United States or from the purchase of personal property without and its sale within the United States, shall be treated as derived entirely from the country in which sold. . . . .

Regulations. Income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which sold. The word "sold" includes "exchanged" and ordinarily means the place where marketed. This article does not apply to income from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States or produced (in whole or in part) by the taxpayer without and sold within the United States. . . . . (Art. 323.)

Items of gross income other than those specified in section 217 (a) and (c) and articles 317-323 shall be allocated or apportioned to sources within or without the United States, as provided in subdivision (e) of section 217.

The income derived from the ownership or operation of any farm, mine, oil or gas well, other natural deposit, or timber, located within the United States, and from the sale by the producer of the products thereof within or without the United States, shall ordinarily be included in gross income from sources within the United States. If, however, it is shown to the satisfaction of the Commissioner that due to the peculiar conditions of production and sale in a specific case or for other reasons all of such gross income should not be allocated to sources within the United States, an apportionment thereof to sources

within the United States and to sources without the United States shall be made as provided in article 327.

Where items of gross income are separately allocated to sources within the United States, there shall be deducted therefrom, in computing net income, the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. (Art. 326.)

The following articles give certain rules for the allocation of income derived from sources partly within and partly without the United States by manufacturers, producers and transportation services.

REGULATIONS. . . . . *Manufacturers and producers.*—Gross income derived from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced in whole or in part by the taxpayer without and sold within the United States shall be treated as derived partly from sources within and partly from sources without the United States, under one of the cases named below. As used herein, the word "produced" includes created, fabricated, manufactured, extracted, processed, cured, or aged.

Case 1: Where the manufacturer or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price—or shows to the satisfaction of the Commissioner that such an independent factory or production price has been otherwise established—unaffected by considerations of tax liability, and the selling or distributing branch or department of the business is located in a different country than that in which the factory is located or the production carried on, the net income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling department at the independent factory price so established. In all such cases the basis of the accounting shall be fully explained in a statement attached to the return.

Case 2: Where an independent factory or production price has not been established as provided under case 1, the net income shall first be computed by deducting from the gross income derived from sources partly within and partly without the United States the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. Of the amount of net income so determined, one-half shall be apportioned in accordance with the value of the tax-

payer's property within and without the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the value of the taxpayer's property within the United States and the denominator of which consists of the value of the taxpayer's property both within and without the United States. The remaining one-half of such net income shall be apportioned in accordance with the gross sales of the taxpayer within and without the United States, the portion attributable to sources within the United States being determined by multiplying such one-half by a fraction the numerator of which consists of the taxpayer's gross sales for the taxable year or period within the United States, and the denominator of which consists of the taxpayer's gross sales for the taxable year or period both within and without the United States. "Gross sales within the United States" means the aggregate amount of all sales made during the taxable year which were principally secured, negotiated or effected by employees, agents, offices, or branches of the taxpayer's business resident or located in the United States.

The term "property" as used in this article includes only the property held or used to produce income which is derived from sources partly within and partly without the United States (excluding all property held or used to produce income which is allocated or apportioned under other articles or paragraphs of these regulations). Such property should be taken at its actual value, which in the case of property valued or appraised for purposes of inventory, depreciation, depletion, or other purposes of the Revenue Act of 1921 shall be the highest amount at which so valued or appraised, and which in other cases shall be deemed to be its book value in the absence of affirmative evidence showing such value to be greater or less than the actual value. The average value during the taxable year or period shall be employed. The average value of property as above prescribed at the beginning and end of the taxable year or period ordinarily may be used, unless by reason of material changes during the taxable year or period, such average does not fairly represent the average for such year or period, in which event the average shall be determined upon a monthly or daily basis. Bills and accounts receivable shall (unless satisfactory reason for a different treatment is shown) be assigned or allocated to the United States when the debtor resides in the United States, unless the taxpayer has no office, branch or agent in the United States.

Case 3: Application for permission to base the return upon the taxpayer's books of account will be considered by the Commissioner in the case of any taxpayer who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more

clearly than the processes or formulas prescribed under cases 1 and 2, the income derived from sources within the United States. (Art. 327.)

A foreign corporation carrying on the business of transportation service between points in the United States and points outside the United States derives income partly from sources within and partly from sources without the United States.

(1) The gross income from sources within the United States derived from such services shall be determined by taking such a portion of the total gross revenues therefrom as (*a*) the sum of the costs or expenses of such transportation business carried on by the taxpayer within the United States and a reasonable return upon the property used in its transportation business while within the United States bears to (*b*) the sum of the total costs or expenses of such transportation business carried on by the taxpayer and a reasonable return upon the total property used in such transportation business. Revenues from operations incidental to transportation services (such as the sale of money orders) shall be apportioned on the same basis as direct revenues from transportation services.

In allocating the total costs or expenses incurred in such transportation business, costs or expenses incurred in connection with such part of the services as were wholly rendered in the United States should be assigned to the cost of transportation business within the United States. For example, expenses of loading and unloading in the United States, rentals, office expenses, salaries and wages wholly incurred for services rendered to the taxpayer in the United States belong to this class. Costs and expenses incurred in connection with services rendered partly within and partly without the United States may be prorated on a reasonable basis between such services. For example, ship wages, charter money, insurance and supplies chargeable to voyage expenses should ordinarily be prorated for each voyage on the basis of the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days on the voyage, and fuel consumed on each voyage may be prorated on the basis of the proportion which the number of miles sailed within the territorial limits of the United States bears to the total number of miles sailed on the voyage. Income, war-profits, and excess-profits taxes should not be regarded as costs or expenses for the purpose of determining the proportion of gross income from sources within the United States; and for such purpose, interest and other expenses for the use of borrowed capital should not be taken into the cost of services rendered, for the reason that the return upon the property used measures the extent to which such borrowed capital is the source of the income. For other expenses entering into the cost of services, only such expenses as are allowable deductions under the Revenue Act of 1921 should be taken.

The value of the property used should be determined upon the basis of cost less depreciation. Eight per cent may ordinarily be taken as a reasonable rate of return to apply to such property. The property taken should be the average property employed in the transportation service between points in the United States and points outside the United States during the taxable year. For ships the average should be determined upon a daily basis for each ship and the amount to be apportioned for each ship as assets employed within the United States should be computed upon the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days the ship was in service during the taxable period. For other assets employed in the transportation business, the average of the assets at the beginning and end of the taxable period ordinarily may be taken, but if the average so obtained does not, by reason of material changes during the taxable year, fairly represent the average for such year either for the assets employed in the transportation business in the United States or in total, the average must be determined upon a monthly or daily basis.

(2) Interest and income, war-profits, and excess-profits taxes should be excluded from the apportionment process, as explained in (1) above; but for the purpose of computing net income, there may be deducted from the gross income from sources within the United States, after the amount of such gross income has been determined, a ratable part (*a*) of all interest (deductible under section 214(a)2 or section 234(a)2) and (*b*) of all income, war-profits, and excess-profits taxes (deductible under sections 214(a)3 and 234(a)3) paid or accrued in respect of the business of transportation service between points in the United States and points outside the United States. Such ratable part should ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income from such transportation service.

(3) If a foreign corporation subject to this article is also engaged in a business other than that of providing transportation service between points in the United States and points outside the United States, the costs and expenses (including taxes) properly apportioned or allocated to such other business should be excluded both from the deductions and from the apportionment process prescribed in (1) above; but, for the purpose of determining net income, a ratable part of any general expenses, losses or deductions which can not definitely be allocated to some item or class of gross income, may be deducted from the gross income from sources within the United States, after the amount of such gross income has been determined. Such ratable part should ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income.

(4) Application for permission to base the return upon the taxpayer's books of account will be considered by the Commissioner in

the case of any taxpayer subject to this article who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which reflects more clearly than the process prescribed in (1) and (2) above the income derived from sources within the United States. (Art. 327 (a), added by T. D. 3387, dated August 23, 1922.)

This article applies only to the 1921 law.[25]

Computation of tax where income is from sources partly within and partly without the United States.—

REGULATION. Where a taxpayer has gross income from sources within or without the United States as defined by section 217 (a) or (c) together with gross income derived partly from sources within and partly from sources without the United States, the amounts thereof, together with the expenses and investment applicable thereto shall be segregated, and the net income from sources within the United States shall be separately computed therefrom. (Art. 328.)

Rulings regarding income from sources partly within and partly without the United States.—While it is difficult to determine from the law and the regulations exactly what constitutes income from sources within the United States, certain items of income received by non-resident aliens have been expressly construed by the Treasury as taxable or non-taxable.

RULING. Where bonds, notes, or other obligations of a foreign Government are underwritten by a United States banking establishment and are by their terms payable at an office of such banking establishment in the United States, interest paid from the United States office to nonresident alien individuals or foreign corporations who are holders of such securities is not to be regarded as income received from a source within the United States. . . . . (C. B. 1, page 99; O. 786.)

Profits on exchange realized on such payments are held to be non-taxable because not realized from sources within the United States.[26] The identity of interest on such securities is lost if the amount collected is credited to an account in a domestic bank and interest is allowed on such balances. Under

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[25] I-45-582; I. T. 1492.
[26] C. B. 1, page 101; O. D. 35.

this condition the interest becomes subject to tax.[27] The following ruling regarding discount on British treasury bills is of interest:

RULING. Where foreign corporations or nonresident alien individuals purchase British Government treasury bills at a discount in United States markets and *collect the same at maturity* either in the foreign country or from the paying agent of that Government in the United States, such discount is not income from sources within the United States and is not subject to tax.

Where foreign corporations or nonresident alien individuals purchase British Government treasury bills at a discount in United States markets and *sell the same at a profit* in the United States, such profit is income from sources within the United States and as such is subject to tax. (C. B. 2, page 103; O. D. 534.)[28]

It has been held that income derived by a foreign partnership from goods purchased in the United States through a purchasing agent in this country and sold in foreign countries is not income from sources within the United States and hence is non-taxable.[29] Salary paid to a non-resident alien employee during a temporary visit to this country on business has been held not to be income from sources within the United States.[30] If an alien comes to this country with merchandise and sells it at a profit, he receives taxable income, irrespective of the time necessary to complete his sales.[31] Interest on tax-free covenant bonds of corporations organized in the United States but doing no business and owning no property therein is taxable when paid to non-resident aliens.[32] A non-resident alien corporation deriving profit from purchase or sale in this country of bank acceptances is taxable on such income, even

[27] C. B. 1, page 183; O. D. 269.

[28] A similar ruling, making a distinction between profit on resale in the United States of foreign government or corporation bonds, which would be taxable, and profit realized at maturity of the bonds, which would not be taxable even though the bonds were paid off in the United States, was contained in a letter from Commissioner Wm. M. Williams to Morris F. Frey, dated March 21, 1921.

[29] C. B. 3, page 128; O. D. 592.

[30] C. B. 3, page 128; O. D. 578.

[31] C. B. 1, page 98; O. D. 291.

[32] [Former Procedure] O. 908 (C. B. 1, page 100), holding such interest to be non-taxable when paid to non-resident aliens, has been revoked by L. O. 1069 (C. B. I-1; page 204).

though the corporation has no office or place of business in the United States.[33] Further information regarding "transacting business within the United States" and income from such sources is afforded by the following rulings:

RULINGS. In construing the provision of article 66 of Regulations 33, revised, that a foreign corporation is liable to tax with respect to income, the source of which is in the United States, and that the "source" as used therein means the place of origin, it is held that the place of origin thus referred to, is not restricted to the place where payment is made, since the place of payment may be arbitrarily selected without relation to the nature of the transaction and is not indicative of the source. Where the income grows out of a business activity in the United States it is immaterial where actual payment is made.

The provision of article 92 of Regulations 45, exempting from tax the charter money on freight shipments received by a foreign owner in regard to a vessel operated between the United States and a foreign port, is limited to foreign steamship companies having no office, connections or agency in the United States, whose vessels only occasionally touch at ports in the United States and who can not otherwise be regarded as doing business therein. (C. B. 3, page 265; O. D. 651.)

Amounts paid to a nonresident alien corporation not having an office or place of business in the United States as compensation for orders secured by it from foreign customers for export booked through such nonresident alien corporation are held not to be income from sources within the United States and not subject to withholding. (C. B. 1, page 232; O. D. 112.)

An amount paid to a foreign corporation, as liquidated damages for breach of contract, is held to be income from sources within the United States and therefore subject to taxation.[34]

RULINGS. Profits derived by a foreign corporation having no office or place of business in the United States from a sale of goods to the United States Government are not subject to any income or profits taxes provided for by the Revenue Act of 1918, where the contract for sale was executed, the goods manufactured and delivered, and payment therefor received by the foreign corporation outside the United States. . . . . (C. B. 4, page 114; Digest A. R. M. 133.)

Certain foreign corporations were organized for the purpose of

[33] C. B. 1, page 232; O. D. 221; and C. B. 2, page 189; O. 1024.
[34] I-39-519; Op. A. G. 5.

manufacturing certain products. The entire capital stock of these companies is owned by a domestic corporation. The companies have executive and administrative offices in the United States, maintained merely for the convenience of the domestic company which owns their stock, the offices which they maintain for business activities being located in the foreign country.

The companies' products are sold in the open market by the foreign organization. Any products sold to citizens of the United States or to domestic corporations are sold f. o. b. shipping point in the foreign country. The merchandise thus sold is invoiced by the United States office, but this is merely a part of the clerical detail. The sales are made by mail or through United States representatives visiting the plants in the foreign country, payments on the contracts being made through the office of the domestic corporation.

Held, that the sales are consummated and the title to the property passes in the foreign country. Any profit derived by the foreign corporations from such sales is not subject to tax under the provisions of the Revenue Act of 1918 as income from sources within the United States. (C. B. 5, page 118; O. D. 1100.)

Inquiry is made whether the compensation received by A, a Canadian citizen residing in Canada, who is employed on a car-ferry operated between a port in the United States and a port in Canada, which car-ferry is under Canadian registry, is subject to withholding.

A nonresident alien individual who receives compensation for services performed on vessels operating between Canada and the United States is held to be in receipt of compensation for services performed partly within and partly without the United States, regardless of the fact that the vessel is under Canadian registry.

In view of the fact that the vessel on which A is employed is a ferryboat making regular trips between a port in the United States and a port in Canada, one-half of such services is performed within the United States and one-half within Canada. One-half of the compensation received by A is, therefore, compensation for services performed within the United States, which is subject to Federal income taxation and subject to the withholding provisions of the Revenue Act of 1921. (I-38-512; I. T. 1449.)

In contrast with the foregoing, it has been held that wages earned by non-resident aliens[35] on vessels plying between continental United States and Porto Rico do not constitute income from sources within the United States.[36] Wages earned by a non-resident alien on occasional coastwise voyages on a

[35] For text of article 93 concerning alien seamen, see *Income Tax Procedure*, 1922, page 1289.

[36] C. B. 2, page 162; O. D. 536.

vessel regularly making foreign voyages have a taxable status.[37]

RULINGS. A steamer engaged in foreign trade which lies for a period of two weeks in United States port for the purpose of completing repairs is deemed to be in such port a reasonable time for the transaction of business and accordingly wages paid to its nonresident seamen during such period are held to be income from sources without the United States and hence are not subject to the withholding provisions of the Revenue Act of 1918. (C. B. 2, page 103; O. D. 559.)

A foreign corporation derives income from sources within the United States in the form of dividends, received from stock owned by it in taxable subsidiary corporations organized and doing business in the United States. A portion of the stock of the foreign corporation is deposited with an American agent, who issues certificates of participation in such stock and the dividends thereon.

Held, that since the foreign corporation derives income from sources within the United States, any dividends received by individual holders of such certificates of participation may be claimed as a credit for the purpose of the normal tax or as a deduction from gross income in the case of corporate holders of such certificates subject in the case of foreign corporation holders to the provisions of section 234 (b) of the statute. (C. B. I-1, page 269; I. T. 1160.)

The fact that foreign steamship companies having agents in the United States, receive income from sources within the United States to the extent of freight charges paid by domestic corporations, does not thereby make them receive income "from sources within the United States" under section 217 of the law.[38] Such instances are purely cases of domicile. To have taxable income, foreign corporations must be domiciled within the jurisdiction imposing the tax, or their property or business must be situated within such jurisdiction so that the income may be said to have a situs therein.[39]

RULING. (1) There is no income from sources within the United States from goods manufactured there unless there is, in the language of section 233 (b),[40] both "manufacture and disposition of goods

[37] C. B. 1, page 183; O. D. 245.
[38] C. B. 5, page 218; O. D. 1024.
[39] C. B. 4, page 280; T. D. 3111.
[40] **[Former Procedure]** According to section 233 (b) of the 1918 law, gross income included "all amounts received (although paid under a contract for sale of goods or otherwise) representing profits on the manufacture and disposition of goods within the United States."

within the United States." The Act taxes only income that accrues within the United States.

(2) The mere buying of goods within the United States, with capital furnished from abroad, to be sold abroad, is not a trade or business exercised in the United States so as to subject the purchaser of the goods to income tax. A merchant exercises his trade where he has his principal place of business, viz., where his profits come home to him.

If income be taxed the recipient thereof must have a domicile within the jurisdiction imposing the tax, or the property or business out of which the income issues must be situate within such jurisdiction so that the income may be said to have a situs therein.

(4) Where a corporation purchases goods abroad and sells them within the United States, the profits accruing from such transactions are profits derived from business carried on within the United States and the gross income from such business is income from sources within the United States.

(5) In the case of a partnership organized abroad, one of whose members is a resident citizen of the United States, and whose business consists in selling abroad goods consigned to it from various parts of the world, including the United States, upon commission, title to the goods never vesting in the firm, but passing directly from the consignors to the purchasers, the business of the United States member consisting of soliciting consignments of goods, disbursing proceeds of sales made abroad in payment to consignors in the United States, attending to the shipment of goods, and making advances to consignors on security of bills of lading and express receipts; the funds for the use of the branch office in the United States being obtained by selling drafts on a foreign city, only the income of the partner resident within the United States is income from sources within the United States and subject to income tax.

(6) A foreign corporation, having its home office abroad, which operates a line of steamships between the United States and foreign ports, consigns its steamships to an American firm, which handles them as agents and brokers, seeing to the entry and clearance of each steamer, the discharge and loading of cargo and supplies, collecting such part of the freight as is prepayable in this country, deducting the amount of its disbursements and charges and remitting the balance to the foreign corporation, derives income from sources within the United States to the extent that it derives income from traffic originating within the United States and is taxable upon such income. . . . . (C. B. 4, page 280; T. D. 3111.)

The place where property may be purchased does not affect the determination of the source from which any profit arising

from its disposition within the United States is derived.[41] Income from property purchased within the United States but sold without is not taxable; income from property purchased without the United States but sold within is taxable. The deciding factor is where the property may be *sold*.[42]

In connection with the foregoing rulings concerning steamship companies and foreign merchants, it is to be borne in mind that the 1921 law contains in section 217 (e) specific provisions providing for the allocation to United States sources of a portion of transportation or other services rendered partly within and partly without the United States and of a portion of the income derived from manufacture and sale when *either* of these operations occurred in the United States. Under the 1918 law profits from manufacturing operations were deemed to have been earned within the United States only when the goods were sold in this country.

Where foreign merchants merely purchase goods in the United States, as distinguished from producing them (in whole or in part) here, and sell them abroad, neither the 1921 nor the 1918 law deems any part of the profit to have arisen within the United States.

RULINGS. Gains from sale in United States of securities purchased within or without the United States should be included in gross income of a nonresident alien and losses from sale in the United States of such securities may be deducted from gross income in computing net income subject to tax. (C. B. I-1, page 113; I. T. 1204.)

Section 217 of the Revenue Act of 1921 must be read in connection with section 213(a) of the same Act. Discount is compensation for the use of money, and consequently represents profit to the lender. The same provisions with respect to the reporting of profits derived from bank acceptances and with respect to withholding, as set forth in Law Opinion 1024 (C. B. 2, pp. 189-191), are applicable under the Revenue Act of 1921.

Therefore, where an agent in this country of a foreign bank, a corporation not having an office or place of business in the United States, purchases in this country bank acceptances at a certain rate

[41] C. B. 4, page 114; O. D. 890.
[42] Law, section 217 (e-2).

of discount, and sells such acceptances for a price greater than the price for which purchased, the amount of gain received as the result of the transaction represents income from sources within the United States, but not such income as is subject to withholding. The interest on call loans, however, made for the account of the foreign bank is income subject to withholding under section 237 of the Revenue Act of 1921. (I-30-429; I. T. 1398.)

The profit arising from the sale within the United States by a nonresident alien partnership to a domestic corporation of a United States patent is taxable income to the nonresident alien individuals from sources within the United States under section 213(a) of the Revenue Act of 1921. (C. B. I-1, page 207; Digest I. T. 1232.)

A nonresident alien author sold to American publishers certain novels and the manuscripts thereof, and an option to purchase all rights of serial publication in the United States in certain literary works when produced. A domestic corporation acting as broker and agent for such author negotiated the contracts within the United States and collects the purchase money from the publishers and forwards it, less commission, to the foreign author. The contracts specifically provide that the manuscripts of the novels shall be delivered at the office of the American publishers and that payment for the rights of serial publication shall be made only if the stories are accepted by the publishers. Held, that the sale of the novels and the rights to publication takes place in the United States and the profit from such sales is income from sources within the United States. (C. B. I-1, page 206; I. T. 1231.)

The foregoing ruling is questionable if it is construed to include as taxable income what in effect are the gross earnings of foreign authors. If the test is the residence of the broker, that fact alone should not control. It would seem that the income is earned partly within and partly without the United States. See also comment on article 92, page 1219.

Ruling. A selling agent of a corporation was required to insure it against any loss upon sales made through him. An amount paid him by the corporation, pursuant to a contract with him in reimbursement of the premiums paid, constitutes a deductible business expense.

These premiums, paid to a foreign corporation having no office or agent in the United States, under a contract of insurance made in a foreign country, are held not to be income to the foreign corporation from sources within the United States. (C. B. I-1, page 113; A. R. R. 723.)

Deductions and Exemptions

The general principle underlying section 217 of the 1921 law is that income which non-resident aliens (whether individuals or corporations) derive from sources within the United States shall be subjected to the same income taxes which have to be paid on similar income received by residents or domestic corporations in the United States. There is, however, certain income which is exempt when received by non-resident aliens, some of it because it is exempt regardless of by whom received and some of it because of specific provisions of law applicable only to non-resident aliens or foreign governments.

Income generally exempt.—Interest from state and municipal bonds, farm loan bonds; property acquired by gift,[43] devise, bequest or descent; proceeds of life insurance paid to an individual upon death of the insured, and similar items expressly stated by law to be exempt from tax when received by a resident, are also exempt when received by a non-resident alien.

Income from United States bonds tax exempt[44] after March 3, 1919.—

Regulation. By virtue of section 4 of the Victory Liberty Loan Act of March 3, 1919, amending section 3 of the Fourth Liberty Bond Act of July 9, 1918, the interest received on and after March 3, 1919, on bonds, notes and certificates of indebtedness of the United States and bonds of the War Finance Corporation, while beneficially owned by a nonresident alien individual, or a foreign corporation, partnership, or association, not engaged in business in the United States, is exempt from all income and war-profits and excess-profits taxes. (Art. 94.)

Income of foreign governments and their representatives.—

Regulation. The exemption of income of foreign Governments applies also to their political subdivisions. Any income collected by foreign Governments from investments in the United States

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[43] Subject to limitation of section 202 (a-2). See page 616 *et seq.*
[44] See Chapter XXV.

in stocks, bonds, or other domestic securities, which are not actually owned by but are loaned to such foreign Governments, is subject to tax. The income from investments in the United States in bonds and stocks and from interest on bank balances received by ambassadors and ministers accredited to the United States and the fees of foreign consuls are exempt from tax, but income of such foreign officials from any business carried on by them in the United States would be taxable.[45] . . . . (Art. 86.)

See comment on page 387.

When earnings from operation of ships are not included in gross income.—Under section 213 (b-8) non-resident alien or foreign corporations are not called upon to include in their gross income earnings derived from the operation of ships under conditions specified in the following regulation.

Regulation. The following additional exclusions from gross income not provided by the Revenue Act of 1918 are allowed by the Revenue Act of 1921:

(1) Income of a nonresident alien or foreign corporation consisting exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and corporations organized in the United States. Any taxpayer claiming this exemption must file, under oath, a statement citing the foreign statute which grants the equivalent exemption and stating fully the facts upon which he relies to establish his claim; . . . . (Art. 89.)

The following countries satisfy the equivalent exemption of section 213 (b-8):

Argentine Republic	I-35-480; I. T. 1430
Venezuela	I-35-480; I. T. 1430
Egypt	I-37-496; I. T. 1441
Siam	I-42-552; I. T. 1473
Norway	C. B. I-1, page 111; I. T. 1328
Sweden	C. B. I-1, page 111; I. T. 1327

The following countries do not satisfy the equivalent exemption of section 213 (b-8):

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[45] Income from sources within the United States received by a foreign ruler in his individual capacity is subject to income tax. Income received by him from property belonging to the Crown is not. (C. B. 2, page 96; O. D. 483.)

Costa Rica	I-44-569; I. T. 1485
Great Britain	I-46-589; I. T. 1496
Finland	I-47-601; I. T. 1503
Peru	I-39-516; I. T. 1452

Allowable deductions.—The deductions of non-resident alien individuals are restricted by statute as follows:

LAW. Section 214. [Non-resident alien individuals] . . . . (b) In the case of a nonresident alien individual, the deductions allowed in subdivision (a), except those allowed in paragraphs (5), (6), and (11), shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in section 217 under rules and regulations prescribed by the Commissioner with the approval of the Secretary. In the case of a citizen entitled to the benefits of section 262 the deductions shall be the same and shall be determined in the same manner as in the case of a nonresident alien individual.

LAW. Section 234. [Foreign corporations] . . . . (b) In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the deductions allowed in subdivision (a) shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in section 217 under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

REGULATIONS. Foreign corporations are allowed the same deductions from their gross income arising from sources within the United States as are allowed to domestic corporations,[46] to the extent that such deductions are connected with such gross income. The proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in Section 217. . . . . (Art. 573.)

The deductions provided for in section 214 shall be allowed to nonresident alien individuals and to citizens of the United States entitled to the benefits of section 262, and the deductions provided for in section 234 shall be allowed to foreign corporations and to domestic corporations entitled to the benefits of section 262, only if and to the extent that they are connected with income from sources within the United States. In the case of nonresident alien individuals,

[46] See Chapters XXX to XXXIX inclusive.

however, (1) losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business, are deductible only if and to the extent that the profit, if such transaction had resulted in a profit, would have been taxable as income from sources within the United States; (2) losses sustained during the taxable year of property not connected with the trade or business if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise are deductible only if the property was located within the United States; and (3) contributions or gifts made within the taxable year are deductible only if made to domestic corporations or to community chests, funds, or foundations created in the United States of the type specified in section 214 (a) (11) and article 251, or to the vocational rehabilitation fund.

Losses embraced under clauses (2) and (3) above are deductible in full from items of gross income specified as being derived in full from sources within the United States, but if greater than the sum of such items, the excess of unabsorbed loss may be deducted from the income apportioned to sources within the United States under the provisions of article 327. Losses embraced under clause (1) are deductible in full (as provided in article 325 or article 326) when the profit from the transaction, if it had resulted in a profit, would have been taxable in full as income from sources within the United States, but should be deducted under the provisions of article 327 when the profit from the transaction, if it had resulted in profit, would have been taxable only in part. The amount of dividends included in the gross income may be deducted or credited, but in the case of a nonresident alien individual, for the purpose of the normal tax only. (Art. 324.)

Ruling. A nonresident alien may not claim a deduction for income tax paid abroad on tax-exempt income from sources in the United States. Such income is not an item of gross income for purposes of Federal income tax. Therefore, the income tax paid to France by reason of the receipt of such income is not a deduction which is properly attributable to any item of gross income from sources in the United States which is required to be reported for income tax purposes. (I-31-438; I. T. 1403.)

Apportionment of deductions.—

Regulation. From the items specified in articles 317-323 as being derived specifically from sources within and without the United States there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions which can not definitely be allocated to some item or class of gross income. The

remainder shall be included in full as income from sources within the United States. The ratable part is based upon the ratio of gross income from sources within the United States to the total gross income.

Example.—A nonresident alien individual derived gross income from all sources for 1921 of $180,000. There was included therein:

$9,000	interest on bonds of a domestic corporation.
4,000	dividends on stock of a domestic corporation.
12,000	royalty for the use of patents within the United States.
11,000	gain from the sale of real property located within the United States.
$36,000	total.

That is, one-fifth of the total gross income was from sources within the United States. The remainder of the gross income was from sources without the United States, determined under article 322 above.

The expenses of the taxpayer for the year amounted to $78,000. Of these expenses the amount of $8,000, including such items as commission paid for the sale of the real property located within the United States and interest on indebtedness incurred to purchase the stock of a domestic corporation, is properly allocated to income from sources within the United States and the amount of $40,000 is properly allocated to income from sources without the United States.

The remainder of the expenses, $30,000, can not be definitely allocated to any class of income. A ratable part thereof, based upon the relation of gross income from sources within the United States to the total gross income, shall be deducted in computing net income from sources within the United States. Thus, there is deducted from the $36,000 of gross income from sources within the United States, expenses amounting to $14,000 (representing $8,000 properly apportioned to the income from sources within the United States and $6,000, a ratable part (one-fifth) of the expenses which could not be allocated to any item or class of gross income). The remainder, $22,000, is the net income from sources within the United States. (Art. 325.)

Filing of returns necessary to secure deductions and credits.—

Regulation. Unless a nonresident alien individual, a foreign corporation, or a citizen of the United States or domestic corporation entitled to the benefits of section 262, shall file, or cause to be filed with the collector, a true and accurate return of income from sources within the United States, regardless of amount, the tax shall be collected on the basis of the gross income (not the net income) from sources within the United States. Where a nonresident alien has various sources of income within the United States, so that from any one

source or from all sources combined the amount of income shall call for the assessment of a surtax; and a return of income shall not be filed by him or on his behalf, the Commissioner will cause a return of income to be made and include therein the income of such nonresident alien from all sources concerning which he has information, and he will assess the tax and collect it from one or more of the sources of income within the United States of such nonresident alien, without allowance for deductions or credits. . . . . (Art. 329.)

Credits allowed to individuals.[47]—Non-resident alien individuals are allowed a specific exemption of $1,000 whatever their status and without regard to the reciprocal provisions extended by the country of which they are nationals; provided, however, that a complete return of income from sources within the United States is filed.[48] No additional allowances are permitted for dependents.

LAW. Section 216. . . . . . **(e) In the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the personal exemption shall be only $1,000, and he shall not be entitled to the credit provided in subdivision (d) . . . .**

REGULATIONS. A citizen entitled to benefits of section 262 and a nonresident alien individual, similarly to a citizen or resident, are entitled for the purpose of the normal tax to the dividend credit described in article 301. They are also entitled in every case to a personal exemption of $1,000, but under no circumstances to any credit for dependents. Under the Revenue Act of 1921, the provisions of tax laws of the foreign country of which a nonresident is a citizen or subject are immaterial, the right to a personal exemption of $1,000 being absolute. (Art. 306.)

Unless a nonresident alien individual, a foreign corporation, or a citizen of the United States or domestic corporation entitled to the benefits of section 262, shall file or cause to be filed with the collector, a true and accurate return of income from sources within the United

[47] **[Former Procedure]** Under the 1918 law credits allowed nonresident alien individuals were the same as in the case of citizens or residents, conditional upon the country of which they were citizens allowing similar credits to citizens of the United States. See 1918 law, section 216 (e). Article 307, Regulations 45 (1920 edition), as amended by T. D. 3290 (C. B. I-1, page 201), enumerates the countries which either impose no income tax or in imposing an income tax allow both a personal exemption and a credit for dependents or allow a personal exemption only.

[48] Art. 329.

States regardless of amount, the tax shall be collected on the basis of gross income (not the net income) from sources within the United States.

. . . . The benefit of the credits allowed against net income for the purpose of the normal tax may not be received by a nonresident alien by filing a claim with the withholding agent, but only by claiming it upon filing a return of income, except as permitted in articles 315 and 364. . . . . (Art. 329.)

The specific exemption is dependent upon the status of the taxpayer on the last day of the period covered by his return.

Ruling. If a nonresident alien husband and wife are living together on the last day of their taxable year, their personal exemption will be $1,000, if they make a joint return. If they make separate returns the personal exemption of $1,000 may be taken by either or divided between them in such proportions as they choose. In the event that a nonresident alien husband and wife are not living together on the last day of their respective taxable years, each will be entitled to a personal exemption of $1,000. (I-28-403; I. T. 1390.)

Credits allowed foreign corporations.—A foreign corporation is allowed the same credits as a domestic corporation, excepting the specific exemption of $2,000 to corporations with income not exceeding $25,000, which is not allowed.[49] A foreign corporation, like a non-resident alien individual, can obtain the full benefit of credits only by filing a complete return of income from sources within the United States.

Income of foreign corporations received on and after March 3, 1919, from bonds, notes and certificates of indebtedness of the United States and bonds of the War Finance Corporation, is exempt from income and profits taxes. Such income is not included in gross income, and, of course, a credit cannot be taken therefor except for such income received prior to March 3, 1919.

As in the case of non-resident alien individuals, a foreign corporation is permitted a credit against its taxes[50] for any amounts withheld at the source. The gross income, in-

[49] See Art. 591.
[50] This should not be confused with credits against income.

cluding income upon which any tax is withheld at source, must be included in the return.

Ruling. The interest upon Treasury certificates of indebtedness, matured December 15, 1921, is exempt from income tax when owned by a foreign corporation not engaged in business within the United States, and a loss incurred by such a corporation upon their maturity is not deductible from the corporation's income received from sources within the United States which consisted of interest on corporate bonds. (I-32-451; I. T. 1415.)

The foregoing ruling does not seem to be sound. As gains derived from the sale of the certificates at a profit would be taxable, losses arising from the sale at a loss should be deductible.

Collection of the Tax

The tax is collected from non-resident aliens in two ways: (1) Payment by the aliens of the tax shown to be due by returns filed; (2) withholding of normal tax at the source in the case of all payments of fixed or determinable annual or other periodical income.[51] In the case of income from which tax is deducted at the source, non-resident aliens are required to include the gross payments in their returns, but a credit is allowed *against tax* for the amount which has been deducted at the source. There is withholding at the source *only* in the case of income described as "fixed or determinable, annual or periodical," and the withholding provisions of the law do not apply to foreign partnerships, except in the case of payment of interest on tax-free covenant bonds. Chapter XIII discusses in detail the use of various forms of ownership certificates and the use of withholding returns in lieu of information returns. Chapter XIV explains the legal theory underlying tax-free covenants in bonds and withholding from citizens, residents, non-resident alien individuals, and domestic or foreign corporations.

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[51] Section 221. See page 1254.

Returns of non-resident alien individuals.—

REGULATION. A nonresident alien individual shall make or have made a full and accurate return on Form 1040B of his income received from sources within the United States, regardless of amount, unless the tax on such income has been fully paid at the source. . . . . The responsible representatives of nonresident aliens in connection with any sources of income which such nonresident aliens may have within the United States shall make a return of such income, and shall pay any and all tax, normal and additional, assessed upon the income received by them in behalf of their nonresident alien principals, in all cases where the tax on income so in their receipt, custody or control shall not have been withheld at the source. . . . . (Art. 404.)

LAW. Section 217. . . . . (g) . . . . **In case of failure to file a return, the collector shall collect the tax on such income, and all property belonging to such nonresident alien individual or foreign trader shall be liable to distraint for the tax.**

If the return of a non-resident alien individual or corporation shows that the amount of tax deducted and withheld at the source is more than the tax found to be due, the excess payment will be refunded upon the filing of a proper claim therefor.[52]

Returns required of aliens to secure sailing permits.—In order that non-resident aliens who are liable to the tax, and who may be temporarily within the United States, shall not depart without paying any tax found to be due and unpaid, the law[53] requires aliens to secure sailing permits, which are not granted until the status of the alien with reference to the tax is determined and any tax due is paid. Section 250 (g) of the 1918 law has been amplified to include specific reference to the cases of departing aliens and imposes a penalty for any attempt to violate this section of the law.

The various instructions issued with respect to departing aliens are not applicable to representatives of foreign countries bearing diplomatic passports.[54]

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[52] C. B. I, page 184; O. D. 107. See also Art. 404.
[53] Section 250 (g), quoted on page 240.
[54] C. B. I, page 252; O. D. 271.

Responsibility of agent for making return.—

REGULATION. . . . . The agent of a nonresident alien is responsible for a correct return of all income accruing to his principal within the purview of the agency. The agency appointment will determine how completely the agent is substituted for the principal for tax purposes. Where upon filing a return of income it appears that a nonresident alien is not liable for tax, but nevertheless a tax shall have been withheld at the source, in order to obtain a refund on the basis of the showing made by the return there should be attached to it a statement showing accurately the amounts of tax withheld, with the names and post-office addresses of all withholding agents. . . . (Art. 404.)

Domestic corporations handling specific transactions for foreign customers but not as agents are not required to file returns or withhold taxes for such customers.

In the case of a commission house in the United States which bought and sold cotton for English mills, the Commissioner ruled as follows on the question of whether either the making of a return or the withholding of tax was required of the commission house.

RULING. . . . . Inasmuch as you state that you have not been designated to act as agent for the foreign corporations in question, to prepare their tax returns, or to otherwise assume general agency obligations, and since you were instructed merely to handle specific transactions for such corporations, the same way that any customer might instruct a stock broker to buy or sell securities for his account, it is held that you were not agent for the foreign corporations in transactions of the character stated, within the meaning of the statute and regulations before mentioned, and, therefore, are not required to file a return for the foreign corporations for whom such purchases and sales were made. . . . . You are not required to withhold the tax from the income accrued to foreign corporations in transactions such as those described, as the income arising therefrom is not deemed to be fixed or determinable annual or periodical income within the meaning of Section 221 of the Revenue Act of 1918 requiring withholding. (Letter of Commissioner D. H. Blair, dated June 8, 1921.)

The fact that a non-resident alien has executed a power of attorney authorizing a domestic bank to act as its agent in all income tax matters, does not relieve a domestic corporation

paying royalties to such non-resident alien from the withholding requirements of the law.

Return for non-resident alien beneficiary.[55]—

REGULATION. Where a citizen or resident fiduciary has the distribution of the income of a trust any beneficiary of which is a nonresident alien, the fiduciary shall make a return on Form 1040 B for such nonresident alien and pay any tax shown thereon to be due. Unless such return is a true and accurate return of the nonresident alien beneficiary's income from all sources within the United States the benefits of the credits and deductions to which the beneficiary is entitled can not be obtained in the return filed by the fiduciary. . . . If the beneficiary appoints a person in the United States to act as his agent for the purpose of rendering income tax returns the fiduciary shall be relieved from the necessity of filing Form 1040 B in behalf of the beneficiary and from paying the tax. In such a case the fiduciary shall make a return on Form 1041 and attach thereto a copy of the notice of appointment. If there are two or more nonresident alien beneficiaries the fiduciary shall render a return on Form 1041 and also a return on Form 1040 B for each nonresident alien beneficiary. . . . . (Art. 425.)

RULING. Where two separate trusts are created for the same nonresident alien beneficiary, each trustee is required to render a personal return on Form 1040 or 1040-A on behalf of the nonresident alien, and pay any and all normal tax found by such return to be due and any and all surtax, provided the income is not returned for the purpose of the tax by the beneficiary.

If one of the trustees is the representative or authorized agent of the nonresident alien, he may render a complete return on Form 1040 or 1040-A, combining the entire net income from both trusts and take credit on the return for any tax paid by the other fiduciary in behalf of the nonresident alien.

If the nonresident alien beneficiary of the two trusts should appoint a resident agent for the purpose of filing his return and paying the tax in his behalf, it would not be necessary for the two trustees to file returns on Form 1040 or 1040-A, provided they have received notice of such appointment. The fiduciaries, however, would not be relieved from liability for rendering returns as such on Form 1041, as required by law. (C. B. 3, page 229; O. D. 572.)

Returns on form 1040 are required even though the alien's income consists entirely of dividends and is less than $5,000.[56]

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[55] See Chapter XLII for general discussion of fiduciaries.

[56] C. B. 1, page 190; O. D. 58.

Record owner of stock is responsible for making return and paying surtax due.[57]—

Regulation. Dividends on stock of domestic corporations or resident foreign corporations are prima facie income of the record owner of the stock, and such record owner will be liable for any additional tax based thereon, unless a disclosure of the actual ownership is made to the Commissioner on Form 1087 which shall show that the record owner is not the actual owner and who the owner is and his address. In all cases where the actual owner is a nonresident alien individual and the record owner is a person in the United States, the record owner will be considered for tax purposes to have the receipt, custody, control, and disposal of the dividend income and will be required to make return for the actual owner, regardless of the amount of the income, and to pay any surtax found by such return to be due. (Art. 405.)

Forms for making individual returns.—

Ruling. Nonresident alien individuals or their authorized agents should use form 1040 (revised) or 1040A (revised) in making returns of income derived from sources within the United States, regardless of amount, unless the tax on such income has been fully paid at the source. If a nonresident alien individual is not liable for any tax which has been withheld at the source, no refund of such tax will be permitted unless such a return is filed and a statement is attached thereto indicating the amounts of the tax withheld and the names and post office addresses of all withholding agents. Unless a nonresident alien individual shall render a return of income, the tax will be collected on the basis of his gross income (not his net income) from sources within the United States. (Extract from T. D. 2815; dated April 2, 1919.)

Form 1040C has been issued for the use of non-resident alien individuals having net incomes of not more than $5,000 for the taxable period 1921. This form is largely used with sailing permits for aliens. In accounting for net incomes of over $5,000, form 1040 must be used, as stated above.

Returns for foreign partnerships.—While foreign partnerships as well as domestic partnerships are not taxed as business entities, returns on form 1065, regardless of the amount of income, are required to show the distributive shares of the

[57] See also Chapter XXVII, page 51, for use of form 1087.

partners, whether or not distributed.[58] Foreign partnerships account only for taxable income from sources within the United States on form 1065, and are required to file returns if they transact business within the United States.

LAW. Section 224. **That every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.**

REGULATION. Every partnership must make a return of income, regardless of the amount of its net income. The return shall be on Form 1065 and shall be sworn to by one of the partners. Such return shall be made for the taxable year of the partnership, that is, for its annual accounting period (fiscal year or calendar year as the case may be), irrespective of the taxable years of the partners. . . . . (Art. 411.)

Returns for foreign corporations.—

REGULATION. Every foreign corporation and corporation satisfying the conditions set forth under section 262, having income from sources within the United States, must make a return of income on Form 1120. If such a corporation has no office or place of business here, but has a resident agent, he shall make the return. It is not necessary, however, for it to be required to make a return that the foreign corporation shall be engaged in business in this country or that it have any office, branch, or agency in the United States. . . . . (Art. 625.)

RULINGS. A foreign corporation engaged in a long-term contract in the United States and receiving part payment on the contract in 1919 is required to file an income-tax return for that year even though it derived no net income from the contract. The return should show the amount received and the election of the corporation to report profit on the contract in the year of completion. (C. B. I-1, page 291; Digest I. T. 1170.)

The M Company and the O Company, who are insurance brokers and agents, when unable to place the insurance desired by their clients with domestic corporations, transmit their clients' requirements to various foreign brokers, who place the insurance with foreign insurance companies. The foreign company which is willing to accept the

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[58] See Chapter XXIX for discussion of partnership income.

risk delivers a policy of insurance to the foreign broker, who transmits it to the M Company or the O Company for delivery to the insured. The foreign broker generally draws a draft at 30 days' sight upon the M Company or the O Company for the premiums due on the insurance placed by them respectively during the past month. The draft is accepted upon presentation and within the next 30 days it is satisfied by the American company, which in the meantime has delivered the policies and collected the premiums. All the dealings of the American companies are with their respective foreign brokers and never with foreign insurance companies. This kind of insurance is not solicited in this country by the foreign insurance companies. The American companies in no instance advance the premiums. They receive no payments of commissions or compensation of any sort from the foreign insurance companies, but the foreign brokers allow them commissions, deducting the amount thereof when they draw drafts upon them. The policies are not signed or countersigned by any American agent.

The M and O Companies may not be required either to file returns as agents of the foreign insurance companies or withhold income tax on premiums forwarded by them to the foreign brokers in connection with such insurance. (C. B. I-1, page 292; Digest I. T. 1359.)

Consolidated returns.[59]—Power is given to the Commissioner to consolidate the returns of foreign corporations whenever he deems it proper to do so. Given this discretion, he should be asked to exercise it where circumstances justify the request and where it would prevent what would otherwise be an evident hardship on the corporations involved.

LAW. Section 240. . . . . (d) For the purposes of this section a corporation entitled to the benefits of section 262 shall be treated as a foreign corporation: *Provided,* That in any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses. . . . .

[59] [Former Procedure] Under the 1917 and 1918 laws no provision was made for the consolidation of returns for foreign corporations. It was provided, however, that in case a domestic corporation controlled a foreign corporation, a credit should be given for taxes paid by the foreign corporation. This provision [section 240 (c)] has been materially modified [it is section 238 (e) of the 1921 law]. See Chapter XXXIII.

Return by agent.—Section 239 provides that "If any foreign corporation has no office or place of business in the United States, but has an agent in the United States, the return shall be made by the agent." (See article 625, page 1251.)

Time and place for filing non-resident individual returns.[60]—

LAW. Section 227. (a) . . . . In the case of a nonresident alien individual returns shall be made on or before the fifteenth day of the sixth month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of June. The Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.

(b) Returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

Time and place for filing corporation returns.—

LAW. Section 241. (a) That returns of corporations shall be made at the same time as is provided in subdivision (a) of section 227, except that in the case of foreign corporations not having any office or place of business in the United States returns shall be made at the same time as provided in section 227 in the case of a nonresident alien individual.

(b) Returns shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.

Returns in respect of money and other property surrendered to the Alien Property Custodian.[61]—

RULING. An attorney in fact to whom property has been turned over by the Alien Property Custodian for transmission to the nonresident alien owner is considered to be the agent of such alien for

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[60] Form 1065 for foreign partnerships is filed under the same conditions as for individuals.

[61] Also see *Income Tax Procedure*, 1922, pages 1304, 1305.

income-tax purposes, with respect to the income of the alien which he recovers from the Alien Property Custodian, and should file returns on behalf of his principal. He should report therein all income accruing to the alien during the years the property was in the hands of the Alien Property Custodian and should pay any tax shown thereon to be due. (C. B. I-1, page 239; I. T. 1207.)

When tax shown to be due by return is payable.—Payment of tax shown to be due by returns as previously described is to be made when returns are filed or in instalments in accordance with the provisions of section 250. (See Chapter XI, page 241 *et seq.*

Extension of time for filing returns.—The 1921 law gives non-resident alien individuals and foreign corporations having no place of business in the United States three months longer for filing returns than is allowed residents of the United States.[62] Consequently it should be possible for most foreign taxpayers to file their returns within the required time without securing an extension. The Commissioner is authorized, however, to grant a reasonable extension of time when good cause therefor exists.

Withholding of tax at the source.—

LAW. Section 221. (a) That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States having the control, receipt, custody, disposal, or payment of interest (except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States and not having an office or place of business therein), rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, of any nonresident alien individual or partnership composed in whole or in part of nonresident aliens (other than income received as dividends of the class allowed as a credit by subdivision (a) of section 216) shall (except in the cases provided for in subdivision (b) and except as otherwise provided in regulations prescribed by the Commissioner under section 217) deduct and withhold from such annual or periodical

[62] See section 227 on page 1253.

gains, profits, and income a tax equal to 8 per centum thereof: ***Provided,*** **That the Commissioner may authorize such tax to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent.**[63]

Regulation. With respect to payments to foreign corporations not engaged in trade or business within the United States and not having any office or place of business therein, withholding is required of a tax of 2 per cent in the case of interest payable upon corporate bonds or other obligations containing a tax-free covenant clause, and of a tax of 12½ per cent (10 per cent during the calendar year 1921) in the case of other fixed or determinable annual or periodical income, other than corporate dividends. . . . . To enable debtors in the United States to distinguish between foreign corporations which have and those which have not any office or place of business in the United States, and also to enable such corporations as have an office or place of business in the United States to claim exemption from withholding the tax on bond interest or other income, a certificate, Form 1086, stating that any such corporation has an office or place of business in the United States should be filed by it with the debtor. (Art. 601.)

Ruling. The obligation of a person in the United States to pay to a foreign bank amounts representing drafts and interest thereon, drawn by him and accepted by the foreign bank, is such an "interest-bearing obligation" as is contemplated by section 233 (b), regardless of the fact that the debt was incurred outside the United States and the interest was paid in a foreign country in foreign money. The interest is subject to withholding. . . . . (C. B. 5, page 229; Digest O. D. 1062.)

Withholding in case of partnerships.—A partnership composed in whole or in part of non-resident aliens, is subject to the withholding provisions of the statute.

Ruling. . . . . Withholding required from payments of income specified in Section 221 (a) Revenue Act of 1921 made to partnerships composed in whole or in part of nonresident aliens. (Telegram signed by Commissioner D. H. Blair, and dated December 8, 1921.)

Nevertheless, the foregoing does not apply in the case of a partnership having an office or place of business in the United States.

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[63] Section 221 (b) dealing with tax withheld on the interest upon obligations of a corporation containing a tax-free covenant clause, and section 237 dealing with withholding at the source in the case of foreign corporations are quoted in Chapter XIV.

Ruling. Section 221 of the Revenue Act of 1921 provides for withholding of a tax equal to 8 per cent from the annual or periodical gains, profits, or income of a partnership composed in whole or in part of nonresident aliens. However, in the case of a partnership having an office or place of business in the United States, withholding will not be required, even though one or more of the members thereof is a nonresident alien; the partnership, however, as agent of the nonresident alien member or members, shall file a return of the income of such nonresident alien member or members in accordance with the provision of article 404 of Regulations 62, ... (C. B. I-1, page 224; T. D. 3268.)

Only fixed or determinable annual or periodical income is subject to withholding.—

Regulation. Only (*a*) fixed or determinable (*b*) annual or periodical income is subject to withholding. Among such income, giving an idea of the general character of income intended, the statute specifies interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, and emoluments. But other kinds of income may be included. (*a*) Income is fixed when it is to be paid in amounts definitely predetermined. On the other hand, it is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. (*b*) The income need not be paid annually if it is paid periodically, that is to say, from time to time, whether or not at regular intervals. That the length of time during which the payments are to be made may be increased or diminished in accordance with someone's will or with the happening of an event does not make the payments any the less determinable or periodical. A salesman working by the month for a commission on sales which is paid or credited monthly receives determinable periodical income. (Art. 362.)

Rulings. The excess of the face value of a so-called bank acceptance as collected at its maturity, over the amount paid therefor by a person collecting the acceptance at maturity, is not interest within the meaning of sections 221 (a) and 237 of the Revenue Act of 1918.

Gains and profits derived from the purchase and sale of so-called bank acceptances are not fixed and determinable annual or periodical income within the meaning of sections 221 (a) and 237, and are not subject to the withholding provisions of the act. . . . . (C. B. 2, page 189; O. 1024.)

The tax should be withheld on payments by an American corporation to a nonresident foreign corporation having no office or place of business within the United States, representing royalties for the use of a patent, regardless of whether the amount paid is an agreed sum or is contingent on profits earned. The entire royalty,

if not unreasonable, may be taken as a deduction by the American corporation. (C. B. 1, page 230; Digest T. B. R. 29.)

Winnings of horses at a race track credited by the racing association to a nonresident alien owner and trainer of the horses winning such amounts are not fixed nor determinable annual or periodical gains, profits, and income within the meaning of section 221 (a), Revenue Act of 1918, and no withholding by the racing association is necessary. (C. B. 1, page 184; S. 975.)

While certain income payments do not require withholding, such payments nevertheless have a taxable status. In other words, relief from withholding does not make income non-taxable.[64]

No withholding from interest on bank balances in certain cases.—Under the 1921 law interest paid to non-resident aliens not having a place of business in the United States, on deposits in domestic banks, is specifically exempt from taxation.[65]

Regulation. Under the Revenue Act of 1921 persons carrying on the banking business within the United States are not required to withhold any tax from interest on bank deposits which is paid to (or credited to the accounts of) persons not engaged in business within the United States and not having an office or place of business therein. Any tax which, subsequent to December 31, 1920, and pursuant to the Revenue Act of 1918, had been withheld by persons carrying on the banking business within the United States from interest on bank deposits paid to (or credited to the accounts of) nonresident alien individuals not engaged in business within the United States and not having an office or place of business therein, or foreign corporations not engaged in business within the United States and not having an office or place of business therein, shall be released and paid over to such nonresident alien individual or foreign corporation, or his or its representative. (Art. 372.)

Rulings. Any amounts which have been withheld for tax since December 31, 1920, from interest on deposits with persons carrying on a banking business paid to persons not engaged in business in the United States and not having an office or place of business therein should be released by the withholding agent and paid over

[64] Section 217 (a).

[65] **[Former Procedure]** Under the 1918 law interest on bank balances paid or credited to non-resident alien individuals or foreign corporations was subject to withholding. See *Income Tax Procedure*, 1921, pages 1010 and 1011.

to the persons from whom they were withheld, or their proper representatives. (C. B. I-1, page 224; I. T. 1233.)

The M bank carries on its books the accounts of a large number of foreign depositors on which interest is paid periodically and has withheld during 1921 a large sum of money to which its depositors have made a claim.

Inquiry is made whether a letter from a nonresident alien individual, a partnership, or the proper officer of a foreign corporation, affirming that he or it is not engaged in business in the United States and that he or it has no office or place of business in the United States, will be accepted as sufficient evidence of the foreign depositor's nonliability to Federal income tax with respect to the interest in question.

Held, that such a letter will not be accepted as sufficient evidence of the foreign depositor's nonliability to Federal income tax with respect to such interest. Such statement should be made under oath. (I-37-500; I. T. 1443.)

Since the interest which is exempt from the withholding provisions of section 221(a) of the Revenue Act of 1921 is limited to "interest on deposits with persons carrying on the banking business," such exemption can not extend to interest upon balances held by import and export firms. (C. B. I-1, page 224; I. T. 1311.)

No withholding on bond interest due prior to March 1, 1913.—

Ruling. Coupons which became due June 1, 1910, presented on behalf of non-resident alien individual owner. Should the federal income tax be withheld therefrom? Please wire reply. (Answer.) Bond interest represents income to taxpayer when due and payable in accordance with article 54, Regulations 45. No tax required to be withheld from interest upon bonds due prior to March 1, 1913, but paid subsequent to that date. (Telegram from Chicago & Northwestern Railway Company and the answer thereto, signed by Acting Commissioner Callan and dated August 26, 1919.)

Who must withhold the tax?—The law holds all individuals, corporations and partnerships having the control, receipt, custody, disposal or payment of interest, rent, salaries, wages, premiums, annuities, compensation or other fixed or determinable annual or periodical income of any non-resident alien, responsible for deducting and withholding the tax therefrom.

Duties and obligations of employers, in connection with withholding, in the case of non-resident aliens employed in the United States.—Employers are held liable for deduction of income tax from salaries, wages, or other fixed or determinable periodical income paid to non-resident alien employees since September 17, 1915, the date of issuance of T. D. 2242, which defined a non-resident alien and prescribed the certificate of residence, form 1078.[66] If it can be established, as provided in articles 312 to 316 that the alien employee had in fact acquired residence, the employer will not be liable for tax, because no withholding is required in case of resident aliens.

Allowance of personal exemption[67] to non-resident alien employee.—

Regulation. A nonresident alien employee may claim the benefit of the credit for personal exemption by filing with his employer Form 1115 duly filled out and executed under oath. On the filing of such a claim the employer shall examine it. If on such examination it appears that the claim is in due form, that it contains no statement which to the knowledge of the employer is untrue, that such employee on the face of the claim is entitled to credit, and that such credit has not yet been exhausted, such employer need not until such credit be in fact exhausted withhold any tax from payments of salary or wages made to such employee. Every employer with whom affidavits of claim on Form 1115 are filed by employees shall preserve such affidavits until the following calendar year, and shall then file them, attached to his annual withholding return on Form 1042, with the collector on or before March 1. In case, however, when the following calendar year arrives such employer has no withholding to return, he shall forward all such affidavits of claim directly to the Commissioner, with a letter of transmittal, on or before March 15. Where any tax is withheld the employer in every instance shall show on the pay envelope or shall furnish some other memorandum showing the name of the employee, the date and the amount withheld. This article applies only to payments of compensation by an employer to an employee. . . . . (Art. 315.)

Form 1115, used to secure relief from withholding by a non-resident alien employee, may also be used by aliens other

[66] See *Income Tax Procedure,* 1920, page 817.
[67] See page 1212 *et seq.*

than employees to establish credit for personal exemption when a complete return of income from sources within the United States is filed.

Ruling. Employers of nonresident aliens will be held responsible only for withholding tax under the provisions of the Revenue Act of 1921 from payments made subsequent to the passage of the Act—3:55 P. M., Eastern time, November 23, 1921.

In many cases nonresident alien employees have filed Form 1115 with their employers claiming the amount of the personal exemption to which they were entitled under the Revenue Act of 1918.

In cases where the amount of the personal exemption claimed on Form 1115 was $1,000 the liability of the employers to withhold on payments in excess of that amount is the same under the Revenue Act of 1918 and the Revenue Act of 1921.

In cases where the personal exemption claimed on Form 1115 was in excess of $1,000, and the payments made to nonresident alien employees during 1921 prior to the passage of the Revenue Act of 1921, amounted to $1,000 or more but less than the exemption claimed, the employers are liable for withholding eight per cent of the amounts paid subsequent to the passage of the Act. The employer is not liable for withholding a tax of eight per cent on the amounts in excess of $1,000 but less than the exemption claimed on Form 1115, which were paid to nonresident alien employees prior to the passage of the Revenue Act of 1921. The nonresident alien employees are required to pay any tax due on such payments.

In cases where the personal exemption claimed on Form 1115 was in excess of $1,000 and the payments made to the nonresident alien employees prior to the passage of the Revenue Act of 1921 were in excess of the exemption claimed, eight per cent was required to be withheld from such excess under the Revenue Act of 1918. Under the Revenue Act of 1921 employers should continue to withhold eight per cent of the amounts paid subsequent to the passage of the Act. In such cases the employer will not be held liable for withholding a tax of eight per cent on the amounts in excess of $1,000 but less than the exemption claimed which were paid to nonresident alien employees prior to the passage of the Revenue Act of 1921 but will be held liable for eight per cent of the amounts in excess of the exemption claimed on Form 1115, paid prior to the passage of the Revenue Act of 1921 and eight per cent of all amounts paid subsequent to the passage of that Act. The nonresident alien employees are required to pay any tax on the payments made in excess of $1,000 and less than the personal exemption claimed on Form 1115.

In cases where the exemption claimed on Form 1115 was more than $1,000 and payments in excess of that amount but less than the

exemption claimed were made prior to the passage of the Revenue Act of 1921 and the nonresident aliens filing such forms and receiving such payments left the service of the employer prior to the passage of the Revenue Act of 1921, no liability on the part of the employer exists for eight per cent of the amounts in excess of $1,000 paid to the former employees. The former employees are required to pay the tax due on such income.

Employees who are citizens of countries which did not satisfy the similar credit requirement of Section 216 (e) of the Revenue Act of 1918, in connection with their salary or other compensation paid during 1921, may claim the benefit of the $1,000 allowed by the Revenue Act of 1921, by filing Form 1115 with their employers not later than February 1, 1922. In such cases any tax which was withheld during 1921 from the first $1,000 of their wages or other compensation should be refunded.

Nonresident aliens are required to file individual returns of income from sources in the United States in all cases in which the total tax on such income has not been paid at the source. The entire income from sources in the United States should be reported in such returns and credit for any tax withheld should be taken against the total tax shown to be due. (Letter to The Corporation Trust Company, signed by Commissioner D. H. Blair, and dated February 7, 1922.)

REFUND OF TAXES ERRONEOUSLY WITHHELD IF ALIEN CANNOT BE FOUND.—

RULING. Tax erroneously withheld from the wages of a nonresident alien seaman, who can not now be located for the purpose of making refund, should be reported on the annual list return, Form 1042, and paid to the Government, and when the seaman is located he should be advised of his right to file claims for refund. (C. B. 1, page 186; O. D. 258.)

ALIEN EMPLOYEES—RESIDENT AND NON-RESIDENT—WITHHOLDING UPON CHANGE OF STATUS.—

RULING. . . . . If the status of a resident employee changes to that of a non-resident alien, the employer should withhold income tax at the rate of eight per cent from all wages paid to the non-resident employee on and after the date on which the employer had knowledge of the change. Although the employee, in such case, will be taxable as a non-resident alien for the entire taxable year during which his status is changed from that of a resident to that of a non-resident alien, the employer will not be held liable for the deduction of income tax with respect to wages paid preceding the knowledge of the employer as to the change in status. (Extract from letter to W. B. Reed, Account-

ing Secretary, National Coal Association, Washington, D. C., signed by Commissioner Daniel C. Roper, and dated August 6, 1919.)

Withholding from bond interest, and ownership certificates required.—

1. FORM 1000 (REVISED).—This form must be used in collecting interest on bonds in all cases in which there is withholding at the source. A tax of 2 per cent must be withheld on bonds of domestic or resident corporations containing a tax-free covenant clause if the owner is (a) a non-resident alien individual or fiduciary, (b) a foreign partnership, (c) a foreign corporation not having an office or place of business within the United States.

If such bonds do not contain a tax-free covenant clause, a tax of 8 per cent must be withheld in the case of non-resident alien individuals or fiduciaries, and 12½ per cent[68] in the case of corporations not having an office or place of business within the United States.

A foreign corporation not engaged in trade or business within the United States but having a fiscal agent in this country is not a resident corporation[69] and should use form 1000 in collecting interest on tax-free covenant bonds of domestic or resident corporations. It is held,[70] however, that a resident fiscal agent or a resident paying agent of a foreign corporation or country which has issued bonds containing a tax-free covenant clause is required to withhold a tax of 2 per cent from interest on such bonds, when form 1000 (revised) is used by (a) citizens or residents not claiming exemption, or (b) domestic or resident partnerships.[71] It will be noted that such a foreign debtor is not required to withhold against domestic or resident corporations owning its bonds.

[68] 10 per cent for 1921.

[69] C. B. 1, page 186; O. D. 144.

[70] Letter to The Equitable Trust Company of New York, N. Y., signed by Paul F. Myers, Acting Commissioner and dated July 7, 1920.

[71] **[Former Procedure]** Corporations classed as personal service corporations (classification discontinued December 31, 1921) also used form 1000 (revised).

Citizens or residents may claim personal exemption on such interest payments by filing form 1001A (revised).

2. FORM 1001 (REVISED).—This form should be used by foreign partnerships in collecting interest on bonds of domestic or resident corporations which do not contain a tax-free covenant clause and by foreign corporations having an office or place of business within the United States, foreign governments and exempt foreign corporations, regardless of whether the bonds contain a tax-free covenant clause or not. There is no withholding if this form is used.

3. FORM 1001A (REVISED).—This form is no longer required with respect to foreign items owned by a non-resident alien individual, a foreign partnership, or a foreign corporation, provided the first bank or collecting agent is satisfied as to such ownership. In such case the foreign item may be stamped "Foreign Owner." (See Art. 1076, Reg. 62.)

4. FORM 1001B.—This form is used by non-resident aliens when a personal exemption is claimed in collecting interest on tax-free covenant bonds.[72]

The use of substitute certificates is not permitted in case of foreign payments.[73]

RULING. In any case where Form 1001B covers bonds the income from which is community income and the form is signed by both husband and wife, such form will be accepted and separate forms executed respectively by husband and wife will not be required. Only one exemption of $1,000 may be claimed. (C. B. I-1, page 218; I. T. 1320.)

REGULATION. (a) When the gross income (including bond interest) of a nonresident alien, which is derived from sources within the United States, does not exceed the personal exemption of $1,000, allowed by section 216 (e), an exemption certificate, Form 1001 B, should be executed and filed with the withholding agent, if any part of the gross income is derived from interest upon bonds or similar obligations of a domestic corporation which contain a tax-free covenant clause. The amount of tax due from the withholding

[72] See page 338 *et seq.*
[73] Art. 368.

agent, as shown by Form 1013, may be reduced by 2 per cent of the aggregate amount of interest payments made to such nonresident alien upon tax-free covenant bonds during the calendar year.

(b) When the gross income of a nonresident alien, derived from sources within the United States, does not exceed $1,000, such person may file with the withholding agent an exemption certificate on Form 1001 C with respect to interest upon bonds or similar obligations of a domestic corporation not containing a tax-free covenant clause. The debtor organization or withholding agent, upon receipt of a properly executed certificate showing that the individual's income does not exceed $1,000, shall release and pay over to such individual upon demand any tax withheld during the preceding calendar year. The tax assessed against the withholding agent and which has not been paid may be made the subject of a claim for abatement to the extent of the amount of excess tax withheld, and refunded to the alien on the basis of this certificate. In case the tax so withheld has been paid to the Government, refund of the tax withheld in the case of non tax-free bonds and similar obligations can only be made to the bond owner or his duly authorized representative.

The exemption certificates, Forms 1001 B and 1001 C, properly executed, may be filed with the debtor organization or its duly authorized withholding agent at any time after the close of the calendar year, but not later than May 1 of the succeeding year. Ownership certificates, however, must be filed in connection with all interest payments upon bonds and similar obligations of domestic corporations in accordance with the regulations, notwithstanding the fact that Form 1001 B or Form 1001 C is filed. (Art. 364.)

Procedure when foreign item is presented without ownership certificate and owner is unknown.—

Regulation. If the foreign item is an interest coupon detached from bonds containing a tax-free covenant clause, issued by a foreign country or corporation having a paying agent in the United States, a statement and ownership certificate Form 1000 shall be furnished as provided in Article 369.

In the case of other foreign items which are received unaccompanied by an ownership certificate and the owner is unknown, a statement shall be required of the payee, showing the name and address of the payee, the name and address of the debtor organization, the date of the dividend check or the maturity of the interest coupon, the name and address of the person from whom the dividend check or interest coupon was received, and a statement that the owner of the securities is unknown to the payee. The first bank receiving such foreign item shall prepare a certificate of ownership, Form 1001A, crossing out the word "owner" and substituting therefor the

word "payee." The first bank shall stamp or write across the face of the certificate "statement furnished," adding the name of the bank. Thereupon the statement and certificate shall be forwarded to the Commissioner, as provided in Article 1079. (Art. 1078.)

Withholding is required at the rates for the year in which coupons are paid, but if they became due and payable in prior years, a claim for refund of excess tax withheld may be made.—

RULING. Income tax should be withheld from interest payments to nonresident aliens upon bonds at rates in force during year in which payments were actually made, although bond interest is held to represent income for year during which coupons became due and payable. Any tax withheld and paid to Government in excess of taxpayer's liability may be adjusted through claim for refund. (C. B. 1, page 182; O. D. 167.)

Filing of return by foreign corporation does not relieve from withholding.[74]—

RULING. A domestic corporation making payments of fixed or determinable annual or periodical income to a nonresident foreign corporation is not relieved from compliance with the withholding requirements of the income tax law on account of the fact that the nonresident foreign corporation has filed Federal income tax returns and claims for refund of excess taxes paid during prior years. (C. B. 4, page 302; O. D. 853.)

Definition of withholding agent. —

REGULATION. . . . . A withholding agent may be a corporation with bonds outstanding, a trustee under a corporate mortgage, or any corporation, partnership or private individual. . . . . (Art. 1533.)

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[74] [Former Procedure]

RULING. "A tax of 10 per cent is required to be withheld from the interest credited by a domestic bank to the account of a foreign corporation not having any office or place of business in the United States regardless of the fact that the foreign corporation intends to file an income tax return covering its income from all sources within the United States." (C. B. 4, page 302; O. D. 910.)

As interest on deposits with domestic banks is no longer taxable to foreign corporations not doing business in the United States, the foregoing ruling is to that extent obsolete.

Assignee must withhold.—

Regulation. . . . . Where in connection with the sale of its property payment of the bonds or other obligations of a corporation is assumed by the assignee, such assignee, whether an individual, partnership, corporation, or a State or political subdivision thereof, must deduct and withhold such taxes as would have been required to be withheld by the assignor had no such sale and transfer been made. . . . . (Art. 365.)

Withholding of tax on royalties.—It would seem that royalties received by a non-resident alien individual from United States sources would be taxable income to that individual under section 217 (a-4) of the 1921 Act. Under section 221 (a) as interpreted by article 362 of Regulations 62, the payer of the royalties would be required to withhold a tax of 8 per cent therefrom. But it would seem that the payer of the royalties could not ordinarily be held to be the agent of the foreign author for the purpose of paying the surtax or of filing a complete return of his income from sources within the United States.

Penalties for failure to withhold.—In case of failure to make returns and payments of tax severe penalties are imposed. (See Chapter VIII.)

Tax withheld must be paid to the government.—

Ruling. A withholding agent is liable for the payment to the Government of the tax required to be withheld under section 221, and may not be relieved from such liability by the filing of a bond by the recipient of the income which is subject to withholding. (C. B. I-1, page 223; Digest I. T. 1357.)

Return of tax withheld.—

Regulation. (*a*) Every withholding agent shall make an annual return to the collector of the tax withheld from interest on corporate bonds or other obligations on or before March 1 on Form 1013. He shall also make a monthly return on Form 1012 on or before the 20th day of the month following that for which the return is made. The original ownership certificates, or the substitute

certificates where authorized, must be forwarded to the Commissioner with the monthly return. (*b*) Every person required to deduct and withhold any tax from income other than such bond interest shall make an annual return thereof to the collector on or before March 1 on Form 1042, showing the amount of tax required to be withheld for each nonresident alien individual, partnership composed in whole or in part of nonresident aliens and not having an office or place of business within the United States, or foreign corporation not engaged in trade or business within the United States and not having any office or place of business therein, to whom income other than bond interest was paid during the previous taxable year. In every case of both classes the tax withheld must be paid on or before June 15 of each year to the collector. . . . . (Art. 371.)

Return for non-resident alien beneficiary.—

Ruling. The regulation requiring the trustee to pay the total tax due upon the trust income payable to a nonresident alien beneficiary can not be waived by the filing in the United States of a return by the beneficiary, as the mere filing of a return by a person not within the jurisdiction of the United States does not insure the payment of the tax shown to be due thereon. Unless the beneficiary has appointed a person in the United States to act as his agent for the purpose of rendering income tax returns, and the trustee has received a copy of the notice of such appointment, the trustee is required to render an income tax return in behalf of the beneficiary and to pay the total tax due.

In cases where the beneficiary has forwarded to the trustee an income tax return of the beneficiary's total income from all sources within the United States, the return filed by the trustee in behalf of the beneficiary and the return of the beneficiary should be forwarded to the collector and the correct amount of tax paid by the trustee. (I-34-467; I. T. 1426.)

Return of income from which tax withheld.—

Regulation. The entire amount of the income from which the tax was withheld shall be included in gross income without deduction for such payment of the tax. But any tax actually so withheld shall be credited against the total tax as computed in the taxpayer's return. . . . . If the tax is paid by the recipient of the income or by the withholding agent it shall not be re-collected from the other, regardless of the original liability therefor, and in such event no penalty will be asserted against either person for failure to return or pay the tax where no fraud or purpose to evade payment is involved. (Art. 375.)

Return of information as to payments to non-resident aliens.[75]—

REGULATION. In the case of payments of annual or periodical income to nonresident alien individuals, partnerships composed in whole or in part of nonresident aliens and not having an office or place of business within the United States, or to foreign corporations not engaged in trade or business within the United States and not having any office or place of business therein, the returns filed by withholding agents on Form 1042 shall constitute and be treated as returns of information. . . . . (Art. 1075.)

License for collection of foreign items.—

LAW. Section 259. **That all individuals, corporations, or partnerships undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks, or bills of exchange shall obtain a license from the Commissioner and shall be subject to such regulations enabling the Government to obtain the information required under this title as the Commissioner, with the approval of the Secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both.**

See also Article 1079 on page 333.

Foreign corporations doing business in the United States must file certificate.—

REGULATION. . . . . To enable debtors in the United States to distinguish between foreign corporations which have and those which have not any office or place of business in the United States, and also to enable such corporations as have an office or place of business in the United States to claim exemption from withholding the tax on bond interest or other income, a certificate, Form 1086, stating that any such corporation has an office or place of business in the United States should be filed by it with the debtor. (Art. 601.)

It has been held that a foreign corporation which in 1898 sold all its property in the United States under an executory contract providing that legal title should remain in the corporation until the final payment of the purchase price in 1912, was not doing business in the United States within the mean-

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[75] See Chapter XIV.

ing of the 1909 law by the mere retention of the legal title and the continuance of corporate capacity.[76]

Withholding in the case of Alien Property Custodian.—For regulations and rulings, see *Income Tax Procedure,* 1922, page 1320.

Taxation of Citizens or Residents of United States Possessions and Persons Deriving Income Therefrom

Citizens of United States possessions taxed as non-resident aliens.—

LAW. Section 260. That any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States, shall be subject to taxation under this title only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources. . . . .

REGULATION. A citizen of a possession of the United States (except the Virgin Islands), who is not otherwise a citizen or a resident of the United States, including only the States, the Territories of Alaska and Hawaii, and the District of Columbia, is treated for the purpose of the tax as if he were a nonresident alien individual. . . . . His income from sources within the United States is subject to withholding. . . . . (Art. 1121.)

Citizens of Virgin Islands.—

LAW. Section 260. . . . . Nothing in this section shall be construed to alter or amend the provisions of the Act entitled "An Act making appropriations for the naval service for the fiscal year ending June 30, 1922, and for other purposes," approved July 12, 1921, relating to the imposition of income taxes in the Virgin Islands of the United States.

REGULATION. . . . . The Act referred to in section 260 of the statute provided that income tax laws then or thereafter in force in the United States should apply to the Virgin Islands, but that the

[76] *Bryant & May, Ltd. v. Scott,* 226 Fed. 875.

taxes should be paid into the treasury of the Virgin Islands. Accordingly, a citizen or resident of the Virgin Islands is taxed there under the provisions of the Revenue Act of 1921. (Art. 1121.)

Ruling. For the purpose of collecting in the Virgin Islands the income tax levied by the Revenue Act of 1921, the provisions of that Act and Regulations 62 pertaining thereto which apply to a resident of the United States are applicable to a citizen of the United States who is a resident of the Virgin Islands. Consequently, whether or not such citizen should file a return in the Virgin Islands or in the United States depends upon the status on the last day of his taxable year. Since the taxpayer in the instant case was not a resident of the Virgin Islands on the last day of his taxable year 1921, he has complied with the requirements of the Revenue Act of 1921 by filing his return and paying his income tax in the United States, even though he took up a residence in the Virgin Islands prior to March 15, 1922. (I-39-518; I. T. 1454.)

Non-residents of Porto Rico or the Philippine Islands.—

Law. Section 261. **That in Porto Rico and the Philippine Islands the income tax shall be levied, assessed, collected, and paid as provided by law prior to the passage of this Act.**[77]

The Porto Rican or Philippine Legislature shall have power by due enactment to amend, alter, modify, or repeal the income tax laws in force in Porto Rico or the Philippine Islands, respectively.

Regulation. (*a*) A citizen of the United States who resides in Porto Rico, and a citizen of Porto Rico who resides in the United States, are taxable in both places, but the income tax in the United States is credited with the amount of any income, war profits, and excess profits taxes paid in Porto Rico. . . . . (*b*) A resident of the United States, who is not a citizen of Porto Rico, is taxable in Porto Rico as a nonresident alien individual on any income derived from sources within Porto Rico, but the income tax in the United States is credited with the tax paid in Porto Rico. (*c*) A resident of Porto Rico, who is not a citizen of the United States, is taxable in the United States as a nonresident alien individual on any income derived from sources within the United States, and receives no such credit. . . . . The same principles apply in the case of the Philippine Islands. (Art. 1132.)

It has been held that a foreign corporation transacting business and having a place of business in both continental United States and in Porto Rico, is not subject to income tax

[77] For the provision of prior laws alluded to in this section, see *Income Tax Procedure,* 1921, page 1022.

in continental United States upon income derived from Porto Rico under the Act of September 8, 1916, as amended by the Act of October 3, 1917.[78] This avoidance of double taxation is further supported by the following regulation.

REGULATION. (*a*) A United States corporation which derives income from sources within Porto Rico, (*b*) a Porto Rico corporation which derives income from sources within the United States, and (*c*) a corporation of a foreign country which derives income both from sources within Porto Rico and from sources within the United States, are all taxable in both places. In the case of the United States corporation the income, war profits, and excess profits taxes in the United States are credited with the amount of any income, war profits, and excess profits taxes paid in Porto Rico. In the case of the Porto Rico corporation there is no such credit. . . . . The corporation of the foreign country deriving income from both places is subject to no double taxation so far as the United States and Porto Rico are concerned. . . . . For the purpose of withholding, a Porto Rico corporation is a foreign corporation. . . . . The same principles apply in the case of the Philippine Islands. (Art. 1133.)

Income from sources within the possessions[79] of the United States.—The hardships that have resulted to taxpayers through double taxation such as existed under the law of 1918, whereby United States citizens resident in the Philippines could be taxed twice upon the same income,[80] was relieved by section (262)[81] incorporated in the 1921 law, effective from January 1, 1921. This section determines the status of citizens resident in possessions of the United States as to whether, for purposes of taxation, they could be considered non-resident aliens or residents.

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[78] C. B. 2, page 260; O. 976.

[79] LAW. Section 262. . . . . (c) As used in this section the term "possession of the United States" does not include the Virgin Islands of the United States.

REGULATION. . . . . The term "possession of the United States" . . . includes Porto Rico, the Philippine Islands, the Panama Canal Zone, Guam, Tutuila, Wake, and Palmyra; it does not include the Virgin Islands. (Art. 1137.)

[80] C. B. 4, page 55; T. D. 3178.

[81] See page 1220.

CHAPTER XLII

FIDUCIARIES

The sections of the 1921 law relating to fiduciaries, which differ in no essential features from those of the 1918 law, have clarified rather than changed the provisions of the 1916, 1917, and 1918 laws.

Fiduciary defined.—A fiduciary is one who occupies a position of peculiar confidence toward others. As a general rule, a fiduciary has legal title to the property and those for whom he acts enjoy the beneficial interest. The law defines a fiduciary as follows:

LAW. Section 200. . . . . **(2) The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person, trust or estate;**[1] . . . .

REGULATION. "Fiduciary" is a term which applies to all persons that occupy positions of peculiar confidence toward others, such as trustees, executors, and administrators, and a fiduciary for income tax purposes is a person who holds in trust an estate to which another has the beneficial title or in which another has a beneficial interest, or receives and controls income of another as in the case of receivers. A committee or guardian of the property of an incompetent person is a fiduciary. . . . . (Art. 1521.)

It has been held that property of enemy aliens which has been seized and is held by the Alien Property Custodian, cannot

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[1] **[Former Procedure]** The act of 1913 included agents in the definition of fiduciaries, but as this clearly did not mean the ordinary agent or attorney, and the Treasury so held, the word was omitted from the 1916 law.

Prior to 1918, agents having the receipt, custody, control and disposal of non-resident alien beneficiaries' income, were considered fiduciaries and as such were required to make return for such beneficiaries, and to pay any and all tax found by such return to be due, provided return was not made by the beneficiary. Since 1918 a fiduciary for a non-resident alien is required to account for any and all normal and surtax upon income paid to such a beneficiary. If this results in payment of excessive taxes, relief can be sought by filing a return and claiming refund.

be said to be held in trust within the meaning of the Revenue Act of 1918.[2] The Alien Property Custodian is construed to be merely an agent or officer of the government and not a trustee or fiduciary such as is required to make returns and pay income tax. While it is held that the custodian is not required to make returns and pay tax, the Treasury, before paying out any funds representing accrual of income during retention of the alien's property by the government, may ascertain the taxes due on such income and require that they be paid.

FIDUCIARY DISTINGUISHED FROM AGENT.—Prior to the 1916 act, the term "fiduciary" was so defined as to include "agent," but the term "agent" has in law a well-recognized meaning which is distinct from that of "fiduciary," and the 1916, 1917 and 1918 acts properly omitted agents from this classification. The 1921 act continues the 1918 definition without change.

An agent may be defined as a representative vested with authority to bring his constituent, called the principal, into contractual relations with others. This authority may be either general or special. If an agent's powers are limited to the performance of specified acts, he is a special agent, while if he has authority to transact generally the business of the principal in regard to which he is employed, he is a general agent.

REGULATION. There may be a fiduciary relationship between an agent and a principal, but the word "agent" does not denote a fiduciary. A fiduciary relationship can not be created by a power of attorney. An agent having entire charge of property, with authority to effect and execute leases with tenants entirely on his own responsibility and without consulting his principal, merely turning over the net profits from the property periodically to his principal by virtue of authority conferred upon him by a power of attorney, is not a fiduciary within the meaning of the statute. In cases where no legal trust has been created in the estate controlled by the agent and attorney the liability to make a return rests with the principal. (Art. 1522.)

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[2] C. B. 3, page 199; Op. A. G. 2.

RULINGS. An oral agreement whereby one of a number of brothers and sisters acts as agent for all of them in managing property held by them as tenants in common under the father's will, and in distributing the income therefrom, is not a legal trust for income-tax purposes, nor is the agent a fiduciary. Each principal should file a separate return including therein his share of the income from the property and claiming a proportionate share of any allowable deductions. (C. B. 2, page 198; O. D. 425.)

By an agreement among owners of unequal portions of a royalty interest in oil and gas wells, A was appointed to receive from the purchaser of the oil and gas, moneys arising from the sale and running of the oil and gas and to account therefor to the signers of the agreement. A also had authority under the agreement to sign division orders respecting the sale and running of the oil and gas from the land. The agreement conveyed no property to A.

Held, that A is an agent of the signers and not a trustee within the meaning of the Revenue Act of 1918 and is not required to file a return on Forms 1040 or 1041 to account for the income received by him. Since the amounts paid over by him to his principals are not fixed and determinable gains, he is not liable for the filing of returns of information under section 256 of the aforesaid Act. . . . . (C. B. 4, page 14; Digest O. D. 875.)

ASSOCIATION[3] DISTINGUISHED FROM TRUST.—

REGULATIONS. Associations and joint-stock companies include associations, common law trusts, and organizations by whatever name known, which act or do business in an organized capacity, whether created under and pursuant to State laws, agreements, declarations of trust, or otherwise, the net income of which, if any, is distributed or distributable among the members or shareholders on the basis of the capital stock which each holds or, where there is no capital stock, on the basis of the proportionate share or capital which each has or has invested in the business or property of the organization. . . . . (Art. 1502.)

Where trustees hold real estate subject to a lease and collect the rents, doing no business other than distributing the income less taxes and similar expenses to the holders of their receipt certificates, who have no control except the right of filling a vacancy among the trustees and of consenting to a modification of the terms of the trust, no association exists and the cestuis que trust are liable

[3] REGULATION. An organization the membership interests in which are transferable without the consent of all the members, however the transfer may be otherwise restricted, and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such, is an association and not a partnership. . . . . (Art. 1503.)

to tax as beneficiaries of a trust the income of which is to be distributed periodically, whether or not at regular intervals. But in such a trust if the trustees pursuant to the terms thereof have the right to hold the income for future distribution, the net income is taxed to the trustees instead of to the beneficiaries. . . . . If, however, the cestuis que trust have a voice in the conduct of the business of the trust, whether through the right periodically to elect trustees or otherwise, the trust is an association within the meaning of the statute.[4] (Art. 1504.)

Three trustees A, B and C, took title to real property. A and B had each an interest of 48 per cent, and C had 4 per cent. The organization was held to be an association because the shareholders were in control of the trust. A died and the legal (not the beneficial) title to his share passed to B. Thereafter it was held to be a trust and not an association, because B as a shareholder did not control the trust.[5]

While the power to terminate a trust is not alone enough to render a trust taxable as an association, retention of substantial control over the management of the trust does operate to make the trust an association within the meaning of the law.[6]

The quesion of substantial control over the management of a trust is one of fact and there must be a clear showing in each case in order that it may be determined whether the trust is to be taxed as an association[7] or not. It was held in *Crocker v. Malley*[8] that:

> . . . . The trustees by themselves cannot be a joint stock association within the meaning of the act unless all trustees with discretion-

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[4] As to Massachusetts trusts, see page 42 *et seq.*

[5] I-41-541; I. T. 1464.

[6] C. B. 3, page 13; Sol. Op. 49.

[7] For ruling on this subject see the following:

C. B. 1,	page 5;	S. 1068		C. B. 3,	page 13;	Sol. Op. 49
" 1,	" 7;	S. 1205		" 3,	" 13;	O. D. 654
" 2,	" 9;	S. 1337		" 4,	" 10;	O. D. 790 and O. D. 868
" 2,	" 11;	O. D. 407		" 4,	" 11;	O. D. 886
" 3,	" 9;	O. D. 598		" 5,	" 12;	T. D. 3193
" 3,	" 9;	O. D. 620.		" 5,	" 186;	O. D. 1040
" 3,	" 10;	Sol. Op. 56				

[8] 249 U. S. 223, 63 L. Ed. 573, 39 Sup Ct. 270, 2 A. L. R. 1601.

ary powers are such, and the special provision for trustees in D [Revenue Act of October 3, 1913, Section II, D] is to be made meaningless.[9]

How Estates and Trusts Are Taxed

Rates of tax.—

LAW. Section 219. (a) That the tax[10] imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including—

Income subject to tax.—

(1) Income received by estates of deceased persons during the period of administration or settlement of the estate;

(2) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(3) Income held for future distribution under the terms of the will or trust; and

(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct. . . . .

Returns by Fiduciaries

LAW. Section 225. (a) That every fiduciary (except a receiver appointed by authority of law in possession of part only of the property of an individual) shall make under oath a return for any of the follow-

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[9] In a later decision the Crocker trust was held to be an association, subject to capital stock tax. See *Malley v. Crocker, et al.*, 281 Fed. 363. The two decisions are not inconsistent, however. The Supreme Court decision involved taxes assessed under the 1913 law. In 1917 "the organization" (of the Crocker trust) "was radically altered. . . . In express terms it agreed that its form should thereafter be 'changed to that of an association' with power to take over and carry on the extensive manufacturing business previously carried on by the corporation whose stock it had held, and any substantially similar business." In the Supreme Court case of *Crocker v. Malley*, it was held that the organization was not an association, In the later case of *Malley v. Crocker*, after the reorganization, the Crocker trust admitted that it was an association. In *Malley v. Howard, Casey v. Howard,* and *Malley v. Hecht*, decided with *Malley v. Crocker*, two other Massachusetts trusts were held to be liable to the capital stock tax, both of which denied that they were associations. The court found that they were actively engaged in business, and, unlike the original Crocker trust, that control was vested in the shareholders rather than in the trustees. It is probable that Massachusetts trust similar in form to the original Crocker trust, would be held to be exempt from capital stock tax.

[10] The tax referred to is the normal and surtax imposed in the case of individuals. (See Chapter IX.)

ing individuals, estates, or trusts for which he acts, stating specifically the items of gross income thereof and the deductions and credits allowed under this title—

When returns are required.—

(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife;

(2) Every individual having a net income for the taxable year of $2,000 or over, if married and living with husband or wife;

(3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income;

(4) Every estate or trust the net income of which for the taxable year is $1,000 or over; and

(5) Every estate or trust of which any beneficiary is a nonresident alien. . . . .

Attention is directed to subdivision (3) in the foregoing. The statute now directs that every individual taxpayer having a *gross* income of $5,000 or more must file a return, but a fiduciary *acting for an estate or trust* need not made a return if the gross income of the estate or trust is over $5,000 but the net income is not in excess of $1,000.

Regulation. Every fiduciary, or at least one of joint fiduciaries, must make a return of income (*a*) for the individual whose income is in his charge, if the gross income of such individual is $5,000 or over, or if the net income of such individual is $2,000 or over if married and living with husband or wife, or is $1,000 or over in other cases, or (*b*) for the estate or trust for which he acts, if the net income of such estate or trust is $1,000 or over, or if any beneficiary of such estate or trust is a nonresident alien. The return in case (*a*) and also in case (*b*), if the tax is payable by the fiduciary, shall be on Form 1040, or on Form 1040 A if the net income does not exceed $5,000. In cases under (*b*) where the tax is payable by the beneficiaries the returns shall be made on Form 1041. In such a case the fiduciary shall include in the return a statement of each beneficiary's distributive share of the net income, whether or not distributed before the close of the taxable year for which the return is made. . . . . If the net income of a decedent from the beginning of the taxable year to the date of his death was at the rate of $1,000 or more a year if unmarried, or $2,000 or more a year if married, or if his gross income for the same period was at the rate

of $5,000 or over a year,[11] the executor or administrator shall make a return for such decedent. . . . . (Art. 421.)

Ruling. If the net income of an estate, covering a period of less than 12 months, when placed on an annual basis does not equal or exceed $1,000, no return for the estate will be required unless its gross income for the period in question was at the rate of $5,000 or over a year. (C. B. I-1, page 241; I. T. 1358.)

The foregoing ruling apparently conflicts with section 225 (a-4) of the 1921 law, which provides that a return is to be made for every estate or trust the net income of which for the calendar year is $1,000 or over. The requirement that a return must be made in cases where the gross income is $5,000 or over does not apply to estates or trusts.

Time for filing returns.—

Law. Section 227. **(a) That returns (except in the case of non-resident aliens) shall be made on or before the fifteenth day of the third month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of March. In the case of a nonresident alien individual returns shall be made on or before the fifteenth day of the sixth month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of June. The Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.. . . .**

Time for filing returns upon death or upon termination of trust.—

Regulations. As soon as possible after his appointment and qualification, without waiting for the close of the taxable year, an executor or administrator shall file a return of income for the decedent. Upon the completion of the administration of an estate and final accounting an executor or administrator shall file a return of income of the estate for the portion of the taxable year in which the administration was closed, attaching to the return a certified copy of the order for his discharge. An ancillary administrator need

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[11] [Former Procedure] The qualification as to gross income was not found in prior laws.

make no separate return if the domiciliary administrator includes in his return the entire income of the estate. Similarly, upon the termination of any other trust the trustee shall make a return without waiting for the close of the taxable year. In any such case the requirements with respect to the payment of the tax are the same as if the return were for a full taxable year closing at the end of the month during which the decedent dies or the estate is settled or the trust is terminated, as the case may be. The payment of the tax before the end of the taxable year in such circumstances does not relieve the taxpayer from liability for any additional tax which might subsequently be imposed upon income of the taxable year. . . . . (Art. 442.)

. . . . If an individual dies during the taxable year, his executor or administrator in making a return for him is entitled to claim his full personal exemption according to his status at the time of his death. . . . . If a husband or wife so dies and the joint personal exemption is used by the executor or administrator in making a return for the decedent, an undiminished personal exemption according to the status of the survivor at the end of the taxable year may be claimed in the survivor's return. If a taxpayer makes a return for a period other than a taxable year, the last day of such period shall be treated as the last day of the taxable year for the purpose of this article. . . . . (Art. 305.)

As soon as possible after an executor or administrator enters upon his duties, he is required to make a return for the decedent up to the date of decedent's death. This is usually for the period from January 1 of the year in which the death occurred, but may be also for the preceding year, as in the case of a man dying in January or February before he had filed his annual return then due for the preceding year. The income tax due from the decedent is a debt against the estate in the hands of the executor or administrator, and the executor or administrator is required to file the return for the decedent in order that the amount due to the government from the decedent's estate may be determined and paid.[12]

It has been held that in case a decedent had been granted an extension of time in which to file a return for a previous taxable period and later died without filing such return, the

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[12] See T. D. 2494, June 2, 1917; also *Income Tax Procedure*, 1920, pages 869-870.

executor or administrator should file, immediately after his appointment or qualification, the return of the decedent and pay tax plus the amount of interest due on the deferred instalments.[13]

If the deceased person kept books on an accrual basis, all income accrued to date of death must be reported in the return made by the executor or administrator covering the period from the beginning of the decedent's taxable year to date of death. If, however, the deceased kept books on a cash receipts basis, only income actually received to date of his death is to be reported on the return.[14] In the case of a deceased member of a partnership[15] the distributive share of the decedent in the profits from the beginning of his taxable year to date of death is to be included. If no other determination were possible, the decedent's share to date of death would presumably be determined by prorating.

In filing a return the executor or administrator may claim, on behalf of the decedent, an exemption of $1,000, $2,000 or $2,500, as the case may be, no matter how small a portion of the year is covered by the return. And he may again claim the full exemption of $1,000 when he later reports the income of the estate for the remaining portion of the year. If the net income of the decedent for the part of the year in which he lived was less than $1,000, if unmarried, or less than $2,000 if married (provided also that his gross income was less than $5,000, when placed on an annual basis as required by section 226 (c) of the law), the executor or administrator need not make any return for him, nor is he required to account for such unreported income when he reports for the estate and its beneficiaries. Such income is entirely ignored so far as the income tax is concerned.

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[13] C. B. 3, page 230; O. D. 681.

[14] C. B. 2, page 170; O. D. 454.

[15] **[Former Procedure]** In the case of a deceased stockholder of a personal service corporation, whose death occurred within the four years immediately prior to December 31, 1921, the distributive share of the decedent in the profits of the corporation from the beginning of his taxable year to date of death was similarly to be included.

Rulings. A taxpayer in October, 1919, converted all of his property into cash and distributed it to his wife and sister, so that at the time of his death in January, 1920, nothing remained to be administered or to satisfy his income tax liability. It is stated that the net income from the operation of his farm in 1919, together with the profit derived from the sale of his property, was sufficient to require a return.

Held, that the gift tended to defeat the intent and purpose of the income tax law and that liability for tax upon the income accruing from the sale attaches to and follows the property distributed into the hands of the recipients; also that a return for 1919 should be filed on behalf of the decedent and that the tax found to be due should be assessed against the estate of the decedent, but that demand for payment should be made upon the recipients of the gift. (C. B. 3, page 211; O. D. 582.)

In case no necessity exists for the appointment of an administrator, the beneficiaries may act jointly, or may duly appoint one of their number as the agent of the estate for the purpose of filing the income-tax return of the decedent. In doing so, however, the agent assumes the responsibility for making the return and incurs the liability to the specific penalties provided for in the case of the filing of erroneous, false, and fraudulent returns. (C. B. 3, page 229; O. D. 702.)

The executor or administrator cannot be held personally responsible for erroneous or fraudulent returns by the decedent, but any additional tax arising from such returns would be a charge against the estate. It might properly be held that he should not make a final distribution until all past returns had been audited.

An administrator or executor may, immediately after his discharge upon final accounting, file with the proper collector of internal revenue a return covering the income and deductions of the estate for the period from the end of the last taxable year to the date of his discharge. To such a return there should be attached a certificate, under seal, setting forth the fact of the final accounting and discharge of the administrator or executor. The tax assessed against that return may be paid immediately after receipt from the collector of a notice of the amount assessed and a demand therefor. It should be understood, however, that if, upon an audit of that return, a

further assessment of tax is made, the administrator or executor will be held liable for its payment.

Place for filing return.—

Regulation. Returns of income must be delivered or mailed to the collector for the district of the legal residence or principal place of business of the person making the return. Persons having no domicile or place of business in the United States, and persons in the military or naval service of the United States, may file their returns of income with the collector at Baltimore. (Art. 447.)

Ruling. In the case where a decedent, a resident of New York, but at the time of her decease living in California, left property in both States, an executor being appointed in each State, it is held that since the entire will was probated in New York and only that part pertaining to the property located in California was probated in that State in conformity with its laws, the executor in California is in fact an ancillary executor and is not required to file a return for the estate, if the domiciliary executor includes in his return the entire income of the estate. (C. B. 3, page 231; O. D. 584.)

See also section 227 (b) on page 75.

One of two or more joint fiduciaries required to file return.—

Law. Section 225. . . . . (b) Under such regulations as the Commissioner with the approval of the Secretary may prescribe a return made by one of two or more joint fiduciaries and filed in the office of the collector of the district where such fiduciary resides shall be sufficient compliance with the above requirement. Such fiduciary shall make oath (1) that he has sufficient knowledge of the affairs of the individual, estate or trust for which the return is made, to enable him to make the return, and (2) that the return is, to the best of his knowledge and belief, true and correct. Any fiduciary required to make a return under this Act shall be subject to all the provisions of this Act which apply to individuals.

Income may be computed on basis other than calendar year.—

Law. Section 212. [Individuals.] . . . . (b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; . . . .

The section is applicable to fiduciaries, because of the definition of taxpayer given in the law, viz., "The term 'taxpayer' includes any person, trust or estate subject to a tax imposed by this Act" (section 1).

Law. Section 219. . . . . (b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, ...

Regulation. While certain estates and trusts are subject to tax as such and others are not, the fiduciary in every case is required to make a return of income. . . . . The net income of an estate or trust shall be computed in the same manner and on the same basis as the net income of an individual, except that in place of the deduction allowed individuals of certain gifts or contributions there may be deducted, without limitation, from the gross income any part of it which during the taxable year is pursuant to the will or trust deed paid or permanently set aside in the manner specified in section 214(a) (11). . . . . (Art. 341.)

Return must show beneficiary's distributive share.—

Law. Section 219. . . . . (b) . . . . In cases in which there is any income of the class described in paragraph (4) of subdivision (a) of this section the fiduciary shall include in the return a statement of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable to each beneficiary, whether or not distributed before the close of the taxable year for which the return is made.

Regulations. In the case of (*a*) estates of decedents before final settlement, (*b*) trusts, whether created by will or deed, for accumulation of income, whether for unascertained persons or persons with contingent interests or otherwise, and in any other case within section 219(a) except paragraph 4 thereof, the income is taxed to the fiduciary as to any single individual, except that from the income of a decedent's estate there may first be deducted any amount of income properly paid or credited to a beneficiary. . . . . Where under the terms of the will or deed the trustee may in his discretion distribute the income or accumulate it, the income is taxed to the trustee irrespective of the exercise of the discretion. The imposition of the tax is not affected by the fact that an ultimate beneficiary may be a person exempt from tax. An allowance paid a widow out of the corpus of the estate is not deductible from gross income. As an intestate's real estate does not pass to his administrator, upon a sale

by the heirs, whether before or after settlement of the estate, each heir is taxed individually on any profit derived. (Art. 342.)

While certain estates and trusts are subject to tax as such and others are not, the fiduciary in every case is required to make a return of income. . . . . (Art. 341.)

The "period of administration or settlement of the estate" is the period required by the executor or administrator to perform the ordinary duties pertaining to administration, in particular the collection of assets and the payment of debts and legacies. It is the time actually required for this purpose, whether longer or shorter than the period specified in the local statute for the settlement of estates. Where an executor, who is also named as trustee, fails to obtain his discharge as executor, the period of administration continues up to the time when the duties of administration are complete and he actually assumes his duties as trustee, whether pursuant to an order of the court or not. . . . . (Art. 343.)

Ruling. An executor or administrator of an estate in process of administration may not, at his option, in rendering the return Form 1040, for the estate, either claim as a deduction the amount of income properly paid or credited during the year to any heir, legatee, or other beneficiary, or compute the net income without the benefit of such deduction and pay the entire tax himself.

Held, in accordance with the provisions of Section 219, subdivision (c) and (d) of the Revenue Act of 1918, that the administrator or executor shall claim in his return, Form 1040, for the estate a deduction for any amount of income properly paid or credited within the year to any legatee, heir, or other beneficiary and that recipient must include such amount in his gross income. This applies to cases of final distribution as well as distribution made during the period of administration. (C. B. 5, page 186; O. D. 967.)

Returns for beneficiaries.—As a general rule, a fiduciary completes his duty as to reporting when he files form 1041. The beneficiary then files on his own behalf form 1040, including therein, among other items, the income he has received from the estate. It should be borne in mind that, although the fiduciary may not have been required to file form 1041, because the payment to each beneficiary was less than $1,000, the beneficiary must nevertheless include the amount he receives from the estate, no matter how small, in his own return.

The fiduciary may, of course, file form 1040, for his beneficiary if he has knowledge of all the income of the beneficiary

from the estate and other sources, provided he has been appointed as agent or attorney-in-fact by the beneficiary for the purpose. In doing so he acts in an entirely separate capacity, performs no duty as a fiduciary and is not thereby relieved from any responsibility as a fiduciary.

Return for non-resident alien beneficiary.—

Regulation. Where a citizen or resident fiduciary has the distribution of the income of a trust any beneficiary of which is a nonresident alien, the fiduciary shall make a return on Form 1040 B for such nonresident alien and pay any tax shown thereon to be due. Unless such return is a true and accurate return of the nonresident alien beneficiary's income from all sources within the United States the benefits of the credits and deductions to which the beneficiary is entitled can not be obtained in the return filed by the fiduciary. . . . . If the beneficiary appoints a person in the United States to act as his agent for the purpose of rendering income tax returns the fiduciary shall be relieved from the necessity of filing Form 1040 B in behalf of the beneficiary and from paying the tax. In such a case the fiduciary shall make a return on Form 1041 and attach thereto a copy of the notice of appointment. If there are two or more nonresident alien beneficiaries the fiduciary shall render a return on Form 1041 and also a return on Form 1040 B for each nonresident alien beneficiary. In no case will a fiduciary be required to withhold tax at the rate of 8 per cent and render a return on Form 1042 with respect to income of a nonresident alien beneficiary, as a complete return thereof will be included in Form 1040 B. . . . . (Art. 425.)

Return by guardian for minor, or by committee for incompetent.—

Regulation. A fiduciary acting as the guardian of a minor having a net income of $1,000 or more, or $2,000 or more, according to the marital status of such person, or having a gross income of $5,000 or over, must make a return for such minor on Form 1040 or 1040 A and pay the tax, unless such minor himself makes a return or causes it to be made. A fiduciary acting as a guardian or the committee of an insane person having an income of $1,000 or more or $2,000 or more, according to the marital status of such person, or having a gross income of $5,000 or over, must make a return for such incompetent on Form 1040 or 1040 A and pay the tax. (Art. 422.)

When there has been a change of guardian during the year, the fiduciary in charge on the last day of the taxable year is

responsible for filing the return for the full year. (C. B. I-1, page 242; I. T. 1185.)

The committee of an incompetent was discharged prior to the end of the year. It has been held that as the former incompetent was under no disability at the end of the year, it was his duty to report for the entire year. It was also held that the committee must file a fiduciary return on Form 1041 if the net income received by it was sufficient to require such a return.[16]

RULINGS. When the property of an Indian is under the control of the Office of Indian Affairs, the United States Government usually holds the property in trust for the Indian, and it is generally within the discretion of the United States what amount of such income shall be paid to the Indian and the time and manner of payment. In such a case the return should be made by the Office of Indian Affairs, by its local superintendent or agent, on behalf of the Government as trustee and the tax assessed upon such return should be paid by the superintendent or agent who makes the return.

In the case of an Indian minor, whose property is controlled by the Office of Indian Affairs, to whom that office pays a small amount each year during his minority and at the time he reaches his majority pays him a lump sum covering, in large part, income received for him by that office for several years prior to the time of such payment, the Indian will not be required to render an income tax return for the taxable year in which he reaches his majority for the purpose of including therein the amount of money received from the Government, but such income should be reported by the Government as trustee for the year in which it was realized. . . . . (C. B. I-1, page 242; Digest I. T. 1366.)

After the death of an insane person, his legal guardian should as soon as possible file a return of the ward's income for the period from the beginning of the taxable year to and including the date of death. (C. B. I-1, page 242; I. T. 1159.)

Trustees in bankruptcy and receivers for individuals are classed as fiduciaries under this law. For a full discussion of their responsibilities, see page 111 *et seq.*

Return when trustees turn property over to administrator for beneficiaries.—

RULING. Under the terms of the will of A, creating a trust in

[16] See I-43-563; I. T. 1480.

favor of his wife which was terminated in 1920, and in accordance with a court order, the trustees paid over to the administrators of A's estate all of the cash and property remaining in their hands after making certain payments to the heirs and legal representatives of A's wife, and the administrators in turn distributed to the beneficiaries under the will all of the cash and property which they held as administrators, including that received from the trustees. The question raised is as to how the income received in 1920 should be reported.

Held, that the trustees should file a return on Form 1041 showing the gross income of the trust and deductions claimed; also the amount of income paid over to the administrators of A's estate and any amount of such income distributed to the heirs or personal representatives of A's wife.

The administrators should file a return on Form 1040 or 1040 A, as the case may be, if the entire net income of the estate, including income received through the trustees, was $1,000 or over. In such return may be claimed a deduction for the entire amount of income received during the year by the administrators, either directly or through the trustees, and properly paid over or credited to the beneficiaries under the will. This return must be accompanied by a statement showing the names and addresses of the beneficiaries to whom income was paid during 1920, and the amount paid to each. . . . . (C. B. 4, page 223; Digest O. D. 806.)

Return where several trusts are created by same person.—

Regulation. In the case of two or more trusts the income of which is taxable to the beneficiaries, which were created by the same person and are in charge of the same trustee, the trustee shall make a single return on Form 1041 for all such trusts, notwithstanding that they may arise from different instruments. When, however, a trustee holds trusts created by different persons for the benefit of the same beneficiary, he shall make a return on Form 1041 for each trust separately. (Art. 423.)

Return by trustee under revocable trust.—For a full discussion of revocable trusts, see page 1297.

Returns for a period of less than twelve months.—

Law. Section 226. . . . . (b) In all cases where a separate return is made for a part of a taxable year the net income shall be computed on the basis of such period for which separate return is made, and the tax shall be paid thereon at the rate for the calendar year in which such period is included.

(c) In the case of a return for a period of less than one year the net income shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in such period; and the tax shall be such part of a tax computed on such annual basis as the number of months in such period is of twelve months.

Regulation. No return can be made for a period of more than twelve months. A separate return for a fractional part of a year is, therefore, required wherever there is a change, with the approval of the Commissioner, in the basis of computing net income from one taxable year to another taxable year. The periods to be covered by such separate returns in the several cases are stated in the statute. The requirements with respect to the filing of a separate return and the payment of tax for a part of a year are the same as for the filing of a return and the payment of tax for a full taxable year closing at the same time. . . . The tax on net income computed on the basis of the period for which a separate return is made shall be paid thereon at the rate for the calendar year in which such period is included. In any case of a return for a period of less than one year the net income shall be placed on an annual basis and the tax computed as provided in subdivision (c) of section 226. . . .

Illustration of computation of tax for a period of less than one year.—For the calendar year 1921 the income tax of a married person entitled to a personal exemption of $2,000, making a return for a six months' period of $10,000 net income, is $995, computed as follows:

Net income	$10,000
Multiplied by 12	120,000
Divided by 6	20,000
Subtracting exemption of $2,000	18,000
Normal tax on $18,000	1,280
Surtax on $20,000	710
Total	1,990
Divided by 2	995

(Art. 431.)

Ruling. The income of a deceased person from the beginning of his taxable year to the date of his death and the income of his estate from the date of his death should be placed on an annual basis as provided by section 226(c) of the Revenue Act of 1921. (C. B. I-1, page 243; Digest I. T. 1251.)

While the provisions of section 226 (c) seem generally to effect a desirable and equitable result, particularly in a case of net income exceeding $1,000 on the annual basis, in which case

a tax would ordinarily be due, it is, however, possible that the statute may be construed by the courts to require a different rule, on the ground that the "net income for the taxable year" mentioned in the statute is the amount actually received during the period covered by the return and not the entirely fictitious amount required to be used by the statute for the computation of the tax. On the other hand, it may be that the language of section 226 (c) will be construed by the courts to provide that the net income is to be placed on an annual basis to ascertain the amount of the net income for the taxable year, for all purposes, as distinguished from the actual net income received during the taxable period.

Information at the source.—

OWNERSHIP CERTIFICATES.—

REGULATION. When fiduciaries have the control and custody of more than one estate or trust, and such estates and trusts have as assets bonds of corporations and other securities, a certificate of ownership shall be executed for each estate or trust, regardless of the fact that the bonds are of the same issue. When bonds are owned jointly by two or more persons, a separate ownership certificate must be executed in behalf of each of the owners. (Art. 374.)

FIDUCIARIES MUST MAKE FULL RETURNS OF INFORMATION.—

RULING. Is any other than a return of income required of a fiduciary?

Yes. Fiduciaries come within the provisions of section 256,[17] of the revenue act of 1918, and will be required to render to the Commissioner of Internal Revenue a return of information, if, during the taxable year, any income has been paid to an individual, partnership, corporation, joint-stock company, etc., equal to, or in excess of $1,000. (*Income Tax Primer,* 1919, question 106.)

In accordance with the provisions of the above-mentioned section, fiduciaries are required to make returns of information regarding all payments of interest, rent, salaries, wages, premiums, annuities, compensation, remunerations, emoluments or

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[17] See page 311 for full text of this section.

other fixed or determinable gains, profits and income (other than payments described in sections 254 and 255) of $1,000 or more in any taxable year.

This obligation is reasonable and can be readily fulfilled by fiduciaries. It is vastly simpler than the cumbersome and annoying system of deduction at the source.

It is incumbent upon fiduciaries not only to furnish the information required but also to assist as far as possible in the securing of returns from beneficiaries, so that no tax shall be lost through the abolition of deduction at the source.

Return forms.—The forms used at present are as follows:

Fiduciary return for estate	No. 1041
Return for minor, etc.	" 1040 or 1040A
Report of information	" 1099
Annual information return	" 1096
Tax withheld	" 1098
Annual return of tax withheld	" 1042

Incidence of Tax on Estate or Trust

Payments to beneficiaries during period of administration not taxable to fiduciary.—

LAW. Section 219. . . . . (c) . . . . **in determining the net income of the estate of any deceased person during the period of administration or settlement there may be deducted the amount of any income properly paid or credited to any legatee, heir or other beneficiary. . . . .**

RULING. Income of an estate during the period of administration which is not paid or credited to the beneficiary is taxable to the estate even though such beneficiary was, as a matter of law, entitled to be paid or credited with such income during that year. (C. B. 1, page 178; Digest T. B. R. 47.)

For procedure under 1916 law, see L. O. 1051 quoted in *Income Tax Procedure,* 1922, page 1349, footnote 28.

An executor or administrator is required to make return

of, *and pay the tax upon,* all income collected by him while the estate is in process of administration, except that he may deduct from the gross income all amounts "properly paid or credited to a beneficiary" (Art. 342). (The beneficiary, of course, must include such income in his or her individual return.) The question of whether income has been "properly paid or credited" may sometimes seem difficult to determine. Under the former statute the Treasury has held that income merely set aside on the books of the executor or administrator as properly due to the beneficiary of a trust can not be considered as "paid or credited" to him, but that to be properly deductible by the fiduciary it must be actually placed within the control of the beneficiary; but the new law adds a new subdivision (e) which provides that any income properly distributable, whether actually distributed or not, shall be allowed as a deduction.

By "beneficiary" here is meant only the person entitled to the income of a trust established by a will. It sometimes happens that an executor during the course of administration of an estate will pay to a beneficiary sums on account of income collected by him. Such payments cannot be considered as income "properly paid or credited to a beneficiary." They must be treated as advance payments to a legatee on account of his legacy, and should not be included in his individual return.

Allowances paid to a widow under an order of court are amounts "properly paid."[18]

RULING. Where a testator left a sum of money in trust with instructions to the trustee to invest it and to pay out of the income certain annuities of specified amounts, said annuities to be paid "free from all Federal, State, city or other taxes, which taxes shall be paid out of the trust estate," liability for payment of income tax on the annuities is that of the beneficiaries and not that of the trust estate. The distributable income passes undiminished by the amount of the income tax and it is not permissible for the trustee to pay the income

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[18] C. B. 4, page 224; O. D. 829.

tax out of the principal so that the beneficiary would not be obliged to return the amount of the annuity as income. (C. B. I-1, page 217; Digest I. T. 1215.)

When income is taxed to beneficiary.[19]—

LAW. Section 219. . . . . (d) In cases under paragraph (4) of subdivision (a), and in the case of any income of an estate during the period of administration or settlement permitted by subdivision (c) to be deducted from the net income upon which tax is to be paid by the fiduciary, the tax shall not be paid by the fiduciary, but there shall be included in computing the net income of each beneficiary that part of the income of the estate or trust for its taxable year which, pursuant to the instrument or order governing the distribution, is distributable to such beneficiary, whether distributed or not, or, if his taxable year is different from that of the estate or trust, then there shall be included in computing his net income his distributive share of the income of the estate or trust for its taxable year ending within the taxable year of the beneficiary. . . .

REGULATION. In the case of (*a*) a trust the income of which is distributable periodically, (*b*) an ordinary guardianship of a minor, and (*c*) an estate of a decedent before final settlement as to any income properly paid or credited as such to a beneficiary, the income is taxable directly to the beneficiary or beneficiaries. Each such beneficiary must include in his return his distributive share of the net income, even though not yet paid him, but if his taxable year is different from that of the estate or trust, then he need only include in computing his net income his distributive share of the income of the estate or trust for its taxable year ending within his taxable year. The regulations governing partnerships are generally applicable to such an estate or trust. . . . . (Art. 345.)

RULINGS. When a trust provides for the distribution of income "when received," the beneficiary should account for it personally whether distributed to him or not. The creator of the trust is not liable for income tax with respect thereto. (C. B. 1, page 180; Digest S. 961.)

The income received by an estate of a deceased person in process of administration has been less than $1,000 per year for several years and has not been distributed by agreement of the beneficiary.

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[19] **[Former Procedure]** The Treasury has held under the 1916 law (not applicable to the laws of 1918 or 1921) that when a beneficiary only received part of the income of the trust in 1917, separate returns should have been filed by the trustees and the beneficiary. (I-46-593; Sol. Op. 146.)

Held, that the distributive share of the beneficiary is not taxable income to him for any year in which the income was accumulated nor for the year in which the accumulated income was paid. (C. B. I-1, page 217; Digest I. T. 1344.)

Three persons acquired by bequest the going business of the testator and operated the same. They were devised also several parcels of real estate, the receipts and expenditures connected therewith not being segregated from the income from the business.

The income from all the property which passed into the hands of the executors upon the death of the testator is taxable to the estate during the period of administration.

There being no partnership relation as to the real estate, the income therefrom is taxable to the devisees in proportion to the amount received by each notwithstanding any charge against it for the payment of legacies. (C. B. I-1, page 214; Digest A. R. M. 151.)

If a trust is irrevocable, there can be no question that the income is taxable to the beneficiary.[20]

As to what may or may not be an irrevocable trust under the circumstances is determined by circumstantial evidence as to the intent of the creator of the trust. The following is a definition given by the Solicitor as to what constituted an irrevocable trust under the laws of the state of Kentucky:

. . . . While it is essential to the creation of a trust that there be an explicit declaration of trust, or circumstances which show beyond reasonable doubt that a trust was intended to be created, no formal or particular words are necessary, but it is sufficient if an intention to create a trust and the subject matter, purpose, and beneficiary are stated with reasonable certainty. Neither is it necessary in all cases that the creator of a trust constitute a third person trustee and transfer the legal title to him, for it is well settled that one may create a trust in his own property by constituting himself trustee, provided his words and acts clearly and unequivocally denote an intention to hold henceforth as trustee for the benefit of another.[21] . . . .

Income of discretionary trust taxable to trustee.[22]—

Ruling. Where the income of a trust fund is payable only in

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[20] For discussion of the taxation of revocable trusts, see page 1297.
[21] C. B. 4, page 108; A. R. R. 492.
[22] [Former Procedure]
Ruling. Where the income of a trust fund is payable only in the dis-

the discretion of the trustees, such income . . . . as is received in 1918 or later years by the trust estate is taxed to the trustees irrespective of the exercise of their discretion.[23] (C. B. 1, page 176; Digest S. 1088.)

As in the application of the estate tax law (q. v.), so with the income tax law, consideration must be given to the laws dealing with the subject of trustees which obtain in the state wherein the estate is situated and which may govern the situation.

It should be noted that the income on which the trustees have paid the tax is tax-free when received by the beneficiaries.

The constructive creation of a trust whereby a beneficiary becomes a fiduciary is shown in the following:

Ruling. A father and son, having acquired from an intestate a life estate and vested remainder respectively in real property in New York, made a joint conveyance of the property for an amount in excess of its value when acquired by them. The proceeds of the sale were placed in a bank in the father's name and they agreed that the father should have the income from the fund for life and upon his death that the principal should go to the son.

Under the laws of the State of New York and by the weight of authority generally, the father is a trustee for the remainderman, his son. The profit derived from the sale represents the undistributable income of a trust entity, and the trustee should file a return on Form 1040 showing the profit from the sale. . . . . (C. B. 5, page 186; Digest O. D. 1040.)

Residuary legatee pays tax—when?—

Ruling. Inasmuch as a residuary estate is the gross estate of the decedent less proper expenses and bequests of specific amounts or specific property, and the specific bequests must be paid in full after all debts and expenses are paid, even though nothing remains to constitute a residue, it follows that if an estate is distributed and no provision made for any part of such expenses or specific bequests, a

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cretion of the trustees, such income as the trustees in their discretion distribute to the beneficiary during the years 1916 or 1917, is taxable to the recipient personally (Act of Sept. 8, 1916, sec. 2 (b).) . . . . (C. B. 1, page 176; S. 1088.)

The tax on the undistributed income was paid by the trustee.

[23] See also I-35-483; I. T. 1431.

proper residue is not obtained and the residuary legatee has received an amount in excess of that to which he is entitled. Therefore, where the estate of a deceased person has been settled, no provision being made for the payment of income tax, the tax assessable is properly collectible from the residuary legatee. (C. B. 3, page 211; O. D. 722.)

Income of each trust separately taxed.—

RULING. Where the same trustee is designated in a will to administer several trusts, the accumulated income of each separate trust will be taxable as an entity, not the income of the trusts combined. (C. B. 1, page 175; O. D. 316.)

When tax is payable by the fiduciary.—

LAW. Section 219. . . . . (c) In cases under paragraphs (1), (2), or (3) of subdivision (a) or in any other case within subdivision (a) of this section except paragraph (4) thereof the tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary,[24] . . . .

The Treasury has uniformly held that income accumulated for the benefit of unborn or unascertained persons or persons with contingent interests is to be taxed to the fiduciary, notwithstanding the fact that specific provision to this effect was not included in the 1913 law. However, the 1916 law (as amended by the 1917 law) and the subsequent laws do make such specific provision.

Prior to July 26, 1915, the Treasury held that under the 1913 law this class of income was not taxable, but on that date issued the following ruling:

RULING. . . . . Any part of the annual income of trust estates not distributed becomes an entity and as such is liable for the normal and additional tax, which must be paid by the fiduciary. When the beneficiary is not *in esse* and the income of the estate is retained by the fiduciary, such income will be taxable to the estate as for an individual and the fiduciary will pay the tax both normal and additional. . . . . (T. D. 2231, dated July 26, 1915.)

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[24] Fiduciaries are classed as individuals, so that payments of the tax must be made as provided in the case of individuals. (See Chapter XI.)

In the case of *First Trust and Savings Bank v. Smietanka,*[25] the court held that this ruling was in error.

DECISION. . . . . This ruling was the cause of the present and other similar suits. It illustrates the not unnatural tendency of tax officers to increase the revenues by implications and strained constructions. The department's first rulings were in harmony with the natural import of the language used by Congress; its later ruling does more than violate the canon that doubts and ambiguities are to go against the government, for it is based, not upon any uncertainty in the terms of the act, but upon a metamorphosis of a body of property into a person, and upon exactions contrary to the exemptions in the act of 1913. If the unascertained residuary legatees were now at hand to receive from the trustee the accumulations of the preceding calendar year, they might be such in number as that nothing but the normal tax on the share of each in excess of his personal exemption could be assessed; but the department, by converting an estate into a personal entity, cuts off all personal exemptions and by adding the shares together subjects each share to the rates of surtaxes that are calculable on the sum total. If the residuary legatee were a charitable or educational institution, the department's method would add to the detriment due to the testator's postponement of the benefit of the taxes and surtaxes throughout the period of postponement. Congress recognized that such alterations and amendments were legislative and passed the amendatory act of September 8, 1916, levying a tax upon undistributed income added to the principal of trust estates.

Income of minors taxable to fiduciary.—Where minors are concerned the procedure required of the fiduciary is outlined in the following:

RULING. . . . . If the minor children are nonresident aliens, the fiduciary is required to make return and to pay the tax thereon, for each of the beneficiaries. If such minors are citizens of the United States, the fiduciary is required to make return for them and to pay the tax, unless such minors themselves make a return or cause it to be made, provided in either instance such minors have a net income of $1,000 or $2,000 according to their marital status. In either event, the return to be made by the fiduciary for each minor child should be on Form 1040 (revised) or 1040-A (revised). (C. B. 5, page 191; O. D. 1085.)

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[25] 268 Fed. 230. (This decision was affirmed by the Supreme Court of the United States, February 27, 1922; — U. S. —, 66 L. Ed. —, 42 Sup. Ct. 223.)

Grantee taxable on income of revocable trust.—It was formerly held[26] that the income of a revocable trust should be included in the gross income of the grantor, on the theory that the income received by beneficiaries under a trust was in the nature of a gift and that the trustees merely acted as agent for the donor, and if the grantor in such cases were permitted to exclude such income from his gross income, it would result in "wholesale evasions of taxes, especially where taxpayers were subject to high surtax."

Little doubt can now exist in the case of most revocable trusts as to the taxable status of grantor and grantee when the grantor conveys and delivers property to a trustee and the latter has sole control over principal and income and no revocation is made prior to the end of the taxable year. It is true that the trustee is an agent, but he is an agent for the grantee as well as for the grantor. Upon the collection of income, title thereto vests in the trustee in trust for the grantee. The question is: "What did the trustee collect?" It would seem that in the absence of revocation up to the date of collection the sole beneficial interest rests in the grantee and the income collected can hardly be said to have been income of the grantor, even constructively or in the hands of his agent. Any act of the grantor must be performed before income arises; therefore failure to act would seem to destroy the agency theory. Certainly if income such as interest and rents which accrue from day to day vests in the trustee in trust for the grantee and becomes the sole property of the grantee, even though the trust is revoked and the principal is withdrawn there is room for argument that such income as accrues to the grantee is taxable income and should not be included in the return of the grantor.

This position is confirmed by a recent ruling under the 1918 law, which held that:

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[26] See Reg. 45, Art. 341; see also C. B. 3, page 202; O. D. 676, C. B. 2, page 176, S. 1344; and C. B. 4, page 221, A. R. R. 521, quoted in *Income Tax Procedure,* 1922, page [illegible] *et seq.*

RULING. Where bonds were conveyed to a trustee under a valid and effective trust, the income to be paid to certain beneficiaries, one of whom was the creator of the trust, and, in addition to the power of revocation, the creator of the trust reserved the right to change, add to, alter, or cancel the lists of beneficiaries, which lists were attached to the trust agreement, and to have set over to him as many of the bonds as were not needed to produce the payments mentioned therein, there should not be included in his gross income any portion of the income other than that received by, or accrued to, him as beneficiary. . . . . (I-30-425; L. O. 1102.)

No specific ruling is available as to the status of revocable trusts when there are several creators. Presumably the same general principle would govern.

Tax payable by estates of non-resident aliens.[27]—

RULINGS. . . . . 1. The undistributed net income of a trust estate under the control of a resident fiduciary and subject to the jurisdiction of a state or territory of the United States, or of the District of Columbia, is taxable in the same manner as income accruing to an unmarried resident individual, irrespective of the fact that the creator of the trust may be a nonresident alien and irrespective of the fact that the ultimate beneficiaries may be nonresident aliens. The exemption to which a single person is entitled may properly be claimed regardless of the citizenship or residence of the creator or of the trust of the beneficiaries for whom the income is retained.

2. The income of an estate in process of administration in the courts of a state or territory of the United States or of the District of Columbia by resident fiduciaries is taxable as an entity, irrespective of the fact that the decedent may have been a nonresident individual and the beneficiaries or distributees may be nonresident aliens and the income may be, in part or in whole, derived from foreign sources. The same specific exemption may properly be claimed as provided for under (1) above. The income taxable to the estate is determined after applying the provisions of section 219 (c).

3. Nonresident alien fiduciaries of trusts subject to the jurisdiction of a foreign country are taxable on undistributed net income from sources within the United States, irrespective of the fact that the creator of the trust or estate may be either a citizen or resident of the United States or a nonresident alien and the beneficiaries may be either citizens or residents of the United States or nonresident aliens. An exemption allowed a single person may properly be claimed, provided the fiduciary is a citizen or subject of a country which

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[27] See Chapter XLI for discussion of taxable status of non-resident aliens.

imposes an income tax and allows a similar credit to citizens of the United States not residing in such country.

4. The income of estates in process of administration in the courts of a foreign country by nonresident alien fiduciaries is taxable as an entity in so far as the income received is from sources within the United States, irrespective of the fact that the decedent may have been either a nonresident alien or citizen of the United States and the beneficiaries in the distribution may be either nonresident aliens or citizens or residents of the United States. The same specific exemption as provided for in (3) above may be claimed under the same conditions and limitations. (C. B. 2, page 172; A. R. M. 37.)

The net income of a discretionary trust which was created by a nonresident alien for the benefit of another nonresident alien is taxable in the hands of a resident fiduciary who is subject to the jurisdiction of a State or Territory of the United States, or the District of Columbia, notwithstanding such income is derived from interest on the bonds of foreign governments and foreign corporations, where the income is not otherwise exempt under the provisions of section 213 (b) of the Revenue Act of 1918. (C. B. 3, page 203; O. D. 743.)

Estate of an enemy alien.—

Ruling. During the period of administration it is the duty of the administrator or executor to make return and pay whatever may be due on income received by the estate of a deceased person. The demand of the Alien Property Custodian for the interest of the beneficiary, who is an alien enemy, entitles the Alien Property Custodian to receive from the administrator or executor the net amount found to be due by the court administering the estate to the alien enemy. After the distribution and receipt by the Alien Property Custodian of the enemy's share in the estate no further tax can be required to be reported or paid by the Alien Property Custodian. However, up to the date of the distribution of the estate it is incumbent upon the administrator or executor to report and pay the income tax due on the estate, the Alien Property Custodian being concerned only with the net amount found to be due the enemy on distribution. In case the property of the enemy is ultimately returned to the enemy such part of the property as represents income of the property taken over by the Alien Property Custodian would be subject to a tax in the hands of the enemy. The question how this shall be collected is a matter of procedure between the Alien Property Custodian's Office and the Internal Revenue Bureau.[28] (C. B. 3, page 203; O. D. 598.)

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[28] See Chapter XLI, page 1253.

Withholding the tax.[29]—The duties of a fiduciary as withholding agent are twofold. On payments to non-resident aliens of rent, salary, interest on debts of the estate and of other fixed or determinable annual or periodical income, he acts in the capacity of a withholding agent and, like any other payer of similar income, he is authorized to accept the same ownership certificates and is required to file the same annual list returns. For a description of his duties in this capacity, see pages 317 and 327, dealing with the collection of the tax at the source on miscellaneous income payable to non-resident aliens.

In his capacity as a fiduciary, when he pays the net income or profits of the estate to the non-resident alien beneficiaries he proceeds as indicated on page 1249 of Chapter XLI, "Non-Resident Aliens." It is not his duty to deduct the tax on payments to citizens or resident beneficiaries.

When the fiduciary pays over any part of the principal or corpus of the estate no tax is due. The tax is deducted only on income payments. Property coming to the estate by gift, bequest, devise or descent may be distributed among the beneficiaries without regard to the tax, since such income is expressly declared to be exempt from the law. Gains or income from such property, however, are taxable.

On payments to non-resident aliens the tax should be deducted regardless of the amount paid. A non-resident alien by filing a complete return of income from sources within the United States may secure the benefit of the personal exemption, if entitled thereto. (See page 1243.)

No penalty for delay in payment in certain cases.—

LAW. Section 250. . . . . (e) If any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, then, except in the case of estates of insane, deceased, or insolvent persons, there shall be added as part of the tax the sum

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[29] [Former Procedure] The previous provisions of law, requiring fiduciaries to withhold the tax at the source, were repealed on October 3, 1917, except as they applied to non-resident aliens.

of 5 per centum on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time it became due: . . . .

Determination of Income Taxable to Fiduciaries and to Beneficiaries

The apportionment of the income of an estate or trust when such income arises from various sources is summarized as follows:

LAW. Section 219. . . . . (e) In the case of an estate or trust the income of which consists both of income of the class described in paragraph (4) of subdivision (a) of this section and other income, the net income of the estate or trust shall be computed and a return thereof made by the fiduciary in accordance with subdivision (b) and the tax shall be imposed, and shall be paid by the fiduciary in accordance with subdivision (c), except that there shall be allowed as an additional deduction in computing the net income of the estate or trust that part of its income of the class described in paragraph (4) of subdivision (a) which, pursuant to the instrument or order governing the distribution, is distributable during its taxable year to the beneficiaries. In cases under this subdivision there shall be included, as provided in subdivision (d) of this section, in computing the net income of each beneficiary, that part of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable during the taxable year to such beneficiary. . . . .

The foregoing covers the procedure when income includes some items taxable to the fiduciary and some taxable to the beneficiary. The method prescribed may be summarized as follows:

1. The *fiduciary* computes net income in the same manner as for an individual, except that deductions may be made,
   - (a) For gifts directed by the will or trust instrument without limitation.
   - (b) For amounts properly *paid or credited* to heirs, legatees, or beneficiaries.
2. The *beneficiary* in computing net income takes account of such items in (a) and (b) above as apply to heirs.

Determination of net taxable income during administration of an estate.—

Regulation. . . . . No taxable income is realized from the passage of property to the executor or administrator on the death of the decedent, even though it may have appreciated in value since the decedent acquired it. In the event of delivery of property in kind to a legatee or distributee, no income is realized. Where, however, the executor sells property of the estate for more than its value at the death of the decedent, the excess is income, or may be capital gain taxable to the estate. . . . . (Art. 343.)[30]

Ruling. A died testate in 1917 and his widow qualified as administratrix with the will annexed in 1918. The entire estate was left to the widow with the exception of 10x dollars which was bequeathed to B. The legacy given to B was paid in 1918 and during that year all debts, taxes and costs of administration were paid in full and the widow, as sole beneficiary, reduced whatever remained to her possession as her personal estate. All the income of the estate since the decedent's death has been reported by the widow in her individual returns. Upon making final report and settlement in 1921 a court order was issued discharging the widow from liability as administratrix.

Held, that inasmuch as the estate of A was in the process of administration until 1921, the widow as administratrix, is required to file a return for the estate for each of the periods from the date of the decedent's death to December 31, 1917, January 1, 1918, to December 31, 1918, January 1, 1919, to December 31, 1919, January 1, 1920, to December 31, 1920, and January 1, 1921, to the date of her discharge, during which the net income of the estate equaled or exceeded $1,000. The return for the period from the date of the decedent's death to December 31, 1917, should be on Form 1040 or 1040A, and the administratrix will be required to pay the tax which may be assessed on the basis of such return. In the event the income of the estate for any of the other periods in question was $1,000 or more as computed without deducting the amount paid or credited to the beneficiary, returns covering such periods should also be made on Form 1040 or 1040A, as the case may be. The returns should be accompanied by a statement showing that during each period the entire net income was paid or credited to the widow as sole beneficiary. . . . . (C. B. 4, page 225; O. D. 926.)

The net income of an estate in the process of administration is ordinarily determined on the same basis and in the same

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[30] For definition of "period of administration," see balance of Art. 343, quoted on page 1284.

manner as in the case of a single individual.[31] except that a credit is allowed for any payments made to a beneficiary and the deduction for charitable contributions (paid or set aside "pursuant to the terms of the will or deed creating the trust"[32]) is not limited to 15 per cent, as in the case of individuals. Income ordinarily exempt when received by individuals, such as proceeds of life insurance,[33] municipal and other exempt bond interest, etc., is also exempt when received by an estate.

A decedent contracts for the sale of certain property and receives, during his lifetime, earnest money binding the contract. After his death and during the period of administration the sale is consummated, title passes and possession is taken by the purchaser. Held that no income accrues from the transaction to either the decedent or the estate.[34] The reason is obvious. No completed transaction occurred during decedent's lifetime; he merely received the cash deposit and retained title to the property. The property, with the contract, passes to the estate of the decedent at his death and is valued for inclusion in the corpus of that estate at the sale price agreed upon by the decedent. When the balance of the purchase money is paid there is no difference between the value of the property on the books of the estate and the amount received therefor. Consequently no gain or loss is realized.

Deductions from gross income.—Current expenses incurred in the management of an estate may be deducted, but the initial expenses may not. The Treasury makes a distinction between such first expenses of the estate as are properly chargeable against the corpus or principal of the estate,

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[31] Estates taxed as entities are allowed an exemption of $1,000 only.

[32] Section 219 (b).

[33] [Former Procedure] Under the 1916 and 1917 laws all proceeds of life insurance policies payable to others than the individual beneficiaries were taxable (section 4). The 1913 law (section B) stated that net income should not include "the proceeds of life insurance policies paid upon the death of the person insured."

[34] C. B. 4, page 224; O. D. 807.

and to that extent reduces the size of the estate, and other management expenses arising from the nature of the properties and details of the business, which are properly deductible from the year's gross income.

Regulation. . . . . Expenses of the administration of an estate such as court costs, attorney's fees and executor's commissions, are chargeable against the corpus of the estate and are not allowable deductions. . . . . (Art. 293.)

Rulings. Executors who continue the trade or business of the decedent may deduct from the gross income of the estate, in computing its net income, all ordinary and necessary expenses paid or incurred during the taxable year in continuing such trade or business, but may not deduct expenses of administration.

The amounts which may be deducted as salaries or other compensation for personal services are limited to a reasonable compensation for personal services actually rendered in continuing the trade or business of the decedent. . . . . (C. B. 4, page 119; Sol. Op. 88.)

By her will the testatrix directed that the residue of her estate, after the payment of certain legacies, should be held by the taxpayer and a corporate trustee in trust to pay certain annuities out of the income thereof, the balance of said income to be paid to taxpayer during his life.

Held, that the commissions paid to the trust company as trustee are allowable deductions from the gross income of the trust, as are also in the present case, the taxes paid to the State upon the property of the trust estate. . . . . (I-29-411; Digest I. T. 1393.)

It is held therefore that trustee's commissions are allowable deductions from the gross income of the trust estate. . . . . (I-29-411; I. T. 1393.)

An assessment levied on bank stock owned by decedent is held by the Treasury to be additional cost of such stock and not a deductible loss.

Ruling. An assessment of 100 per cent on the par value of bank stock paid by the executor of the estate of a deceased stockholder in fulfillment of a statutory liability is not deductible from the gross income of the estate. The amount so paid should be added to the fair market value of the shares as at the date of the testator's death and the resultant sum used as a basis in determining gain or loss realized upon final disposition of the shares of bank stock by the executor. . . . . (C. B. 4, page 213; Digest O. D. 918.)

Gain or loss from sale of stock received as stock dividend.—The manner of determining gain or loss from the sale of stock acquired as stock dividend is fully discussed and exemplified in Chapter XXVIII.

The taxability of the income of a trust estate arising from such a source is dealt with in the following ruling:

RULING. . . . . If the income of the trust estate is distributable periodically, including any profit realized on the sale of such capital assets belonging to the estate, any gain realized from the sale of such capital assets is taxable income to the beneficiaries regardless of whether distributed or not. If the income of the trust estate is not distributable or is distributable in the discretion of the trustee, any profit realized from the sale of capital assets is taxable in the hands of the trustee regardless of whether distributed or not. As will be noted from Article 1547 of Regulations 45, any loss sustained on the sale of capital assets is available as a deduction only to the fiduciary of the estate or trust in determining the income of the estate or trust taxable to the fiduciary and such loss is not available to the beneficiaries who are taxed on their actual distributable income. In the case of stock received as a stock dividend being distributed to the beneficiaries by the fiduciary, this would constitute a distribution in kind of the property of the estate and no taxable gain or deductible loss results to the beneficiaries until such stock is sold or otherwise disposed of by them. (Letter to the Safe Deposit and Trust Company, Baltimore, Maryland, signed by E. H. Batson, Deputy Commissioner, dated December 8, 1921.)

For a more recent ruling regarding stock dividends received by life tenants, see page 1320.

Federal estate tax deductible.—The federal estate tax is properly deductible from the gross income of the estate in the year in which it is paid, if a return has been filed and the tax paid in good faith, whether the tax has previously "accrued" or has not yet accrued. The regulations provide that the tax is deemed to have accrued on the due date thereof, namely, one year after the decedent's death, but they also provide that the tax may be paid upon the filing of a return; which may be done before the expiration of a year from decedent's death. The following is the regulation on this point.

Regulation. Federal estate taxes, paid or accrued during the taxable year, are an allowable deduction from the gross income of the estate in computing the net income thereof, subject to tax. The whole amount of such taxes, irrespective of when paid, is deemed to have accrued on the due date thereof, namely, one year after the decedent's death, and, if the accounts of the estate are kept on an accrual basis, are deductible from gross income of the taxable year in which such due date falls, or for the taxable year in which paid, if paid before the due date. If the accounts are kept on the basis of cash receipts and disbursements, deduction may be taken from gross income of the taxable year or years in which the payment or payments may have been made.

Estate, succession, legacy, or inheritance taxes, imposed by any State, Territory or possession of the United States, or foreign country, are deductible by the estate, subject to the provisions of section 214, where, by the laws of the jurisdiction exacting them, they are imposed upon the right or privilege to transmit rather than upon the right or privilege of the heir, devisee, legatee, or distributee, to receive or to succeed to the property of the decedent passing to him. Where such taxes are imposed upon the right or privilege of the heir, devisee, legatee, or distributee, so to receive or to succeed to the property, they constitute, subject to the provisions of section 214, an allowable deduction from his gross income.

Where, in accordance with a direction contained in the testator's will, the taxes upon the right to receive any particular devise or devises, legacy or legacies are so payable as to relieve the particular devisee or devisees, legatee or legatees from the burden thereof, then the person or persons entitled to the fund or other property out of which payment is made may not take deduction of the taxes so paid, but deduction thereof is available only by such devisee or devisees, legatee or legatees; each, if there be more than one, being authorized to deduct such part of the taxes so paid as he would otherwise have been entitled to do had there been no such testamentary direction.

Where there is a life estate and a remainder, and, by the laws of the jurisdiction imposing them, the taxes in respect to both interests are payable out of the remainder interest, with no legal obligation imposed whereby the remainderman is entitled to reimbursement, then deduction of the taxes so paid may be taken only by the remainderman. Where, in the case of an annuity, the taxes in respect thereto are, by the laws of the jurisdiction imposing them, payable in the first instance out of the fund set aside for creating the annuity, but are to be repaid or restored to such fund from the annuity, then deduction thereof may be taken only by the annuitant.

The accrual dates of such taxes shall be the due date thereof except as otherwise provided by the law of the jurisdiction imposing them. Where deduction is claimed of any such taxes, the amount

thereof and the name of the State, Territory, or possession of the United States or foreign country, by which they have been imposed shall be stated in the return. (Art. 134, as amended by T. D. 3411, November 24, 1922.)

In a recent case it was ruled that federal estate tax paid subsequent to the complete administration of the estate by trustees to whom the property has been conveyed, may not be deducted from the gross income of the trust. (I-46-592; A. R. R. 1020.)

State inheritance taxes.—Whether or not state inheritance taxes are deductible depends on the interpretation of the laws of the particular state. If the tax is imposed upon the right of the beneficiary to receive the property of the decedent, it would not be allowed as a deduction to the estate, but could be taken by the beneficiary. But if the tax is imposed on the right to transmit a decedent's property, it would be an allowable deduction from the gross income of the decedent's estate only.

See Chapter XLV on Federal Estate Tax for further discussion of this question.

Inheritance taxes imposed by Alaska and by the states of Arizona, Arkansas, California, Connecticut, Colorado, Delaware, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Massachusetts, Michigan, Minnesota, Missouri, Montana, New Jersey, New York, North Carolina, Oklahoma, Ohio, Oregon, Texas, Tennessee, Virginia, Wisconsin and Wyoming, have been held to be properly deductible from the income of the beneficiary.[35] The tax imposed by Utah is deductible from the income of the estate.

The state of Rhode Island imposes death duties of two kinds. That portion imposed upon the rights of the several beneficiaries to receive, is deductible from their gross income

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[35] I-42-553, I. T. 1474; I-43-559, I. T. 1477; I-44-571, I. T. 1487; C. B. I-1, page 139, I. T. 1296; I-47-602, I. T. 1504; I-45-581, I. T. 1491; I-48-615, I. T. 1512; and I-50-637, I. T. 1527.

by the beneficiaries and that portion imposed upon the right to transfer or transmit, is deductible from the gross income of the estate. (C. B. I-1, page 139; I. T. 1295.)

Other taxes.—Taxes or assessments for local benefits are not ordinarily deductible.[36] It has been held that where such taxes are paid by a tenant on behalf of, and under agreement with, his landlord, they may be considered as additional rent paid by the tenant.[37] When such rent is a business expense the item would, therefore, be deductible in determining net taxable income.

Losses not deductible by the estate.—

RULING. The worthlessness of corporate stock of the decedent having been determined by an appraisal in a State court made for the purpose of the transfer tax, its cost or other basis constitutes an allowable deduction in the return for the decedent for the last taxable period preceding his death. (Also sec. 219, art. 343.) (I-27-389; Digest I. T. 1381.)

Prior to the passage of the 1921 law such deductions could only be made when the loss was realized. (C. B. 1, page 180; O. D. 219.)

In Chapter XXXI, "Deductions for Expenses," deductions for exhaustion of the principal of life or other terminable interest acquired by gift, bequest, or inheritance are discussed, particularly having regard to section 215 (b) of the 1921 law, which specifically forbids such deductions by beneficiaries of such interest.

Expenses connected with sale of property deductible—when?—

RULING. An executor who pays to another, as agent, a commission upon the sale of property belonging to the estate may deduct from the selling price the amount so paid in determining the gain or loss arising from the sale.

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[36] Law, section 214 (a) (3) and (c).
[37] C. B. 2, page 123; O. D. 373.

An executor who retains as his commission a portion of the amount received by him from the sale of property belonging to the estate may not deduct the amount in preparing a return for the estate since any service performed by him in that connection is deemed to be a part of his duties as executor. Such a commission, however, should be included in the gross income reported in the executor's personal return for the year in which received.

Where property owned by an estate is sold, the amount of the stamp tax upon the deed conveying title to the property constitutes an allowable deduction in the return of the estate. (C. B. 3, page 204; O. D. 632.)

Deduction for depreciation.[38]—In the illustration of article 347,[39] the fiduciary (for the estate or trust) receives credit for the actual depreciation. The following quotation from Bulletin "F" indicates the solution, showing that whether or not the estate is treated as a unit, depreciation will be allowed.

Ruling. An individual who receives income from a trust estate may not deduct from gross income in his individual income tax return any amount representing depreciation of property belonging to the estate. However, under the Revenue Act of 1918 it is permissible for the fiduciary in ascertaining the net income of the estate or trust for which he acts to deduct a reasonable allowance to cover the depreciation sustained during the taxable year, whether or not the terms of the will or agreement creating the estate or trust or a decree of court provide for taking care of the depreciation which may be sustained on the property held in trust.

Estates and trusts in certain circumstances are treated as units and in other cases may represent aggregates of distinct interests, to all of which the fiduciaries are responsible. Irrespective of whether the estate or trust is or is not treated as a unit, the fiduciary in computing the net income upon which he is required to pay the tax may claim a deduction for depreciation in accordance with section 214 (a) 8 Revenue Act of 1918 and articles 161-171 Reg. 45. See also T. D. 2987. (Bulletin "F," page 32.)

Deductions for net losses.—The provisions in section 204 of the 1918 law for the deduction of net losses sustained during any taxable year ended October 31, November 30, or December 31, 1919, has, with some modification, been revived

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[38] See Chapter XXXVI.
[39] See page 1315.

in the new law and made effective from January 1, 1921. Under the 1918 law the net loss arrived at in accord with the requirements of this section was deducted from the prior year's income, so far as such income permitted, and the balance, if any, was deductible from the following year's income. The 1921 law, however, assigns all deductions in this respect to future years only.[40]

Law. Section 204. . . . . **(c) The benefit of this section shall be allowed to the members of a partnership and the beneficiaries of an estate or trust, ...**

(d) If it appears, upon the production of evidence satisfactory to the Commissioner, that a taxpayer having a fiscal year beginning in 1920 and ending in 1921 has sustained a net loss during such fiscal year, such taxpayer shall be entitled to the benefits of this section in respect to the same proportion of such net loss which the portion of such fiscal year falling within the calendar year 1921 is of the entire fiscal year.

The benefit is extended to beneficiaries, as such. Assume a year's income from an estate during the period of administration to be made up as follows:

Net income from investments	$60,000
Loss on operation of decedent's business........	20,000
Net income of estate	$40,000

Under the terms of the will the income from the investments was to be distributed among two beneficiaries in equal shares. The earnings of decedent's business went to a third beneficiary and formed his only source of income. The first two beneficiaries receive their $30,000 each; the latter receives nothing, since there were no earnings from the business, but a loss instead. Under section 204 of the law, however, the $20,000 loss will be deductible in the two succeeding taxable years to the extent that the income during those years shall be sufficient to equal the loss.

The inclusion of beneficiaries specifically in this provision is intended to remove any question that might otherwise arise

[40] See page 965 *et seq.*

as to their status in relation thereto. A fiduciary who carries on the regular business of the decedent and distributes the income therefrom to beneficiaries as and when received, would not be subject to tax. The beneficiaries pay the tax under such circumstances.[41] Without the provision under discussion it might technically be held, under these conditions, that the law did not permit the deduction by a beneficiary of net losses.

Deduction for contributions.—

LAW. Section 219. . . . . (b) . . . . except that (in lieu of the deduction authorized by paragraph (11) of subdivision (a) of section 214) there shall also be allowed as a deduction, without limitation, any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in paragraph (11) of subdivision (a) of section 214. . . . .[42]

RULING. The amount of undistributed net income which is retained and permanently set aside for certain charitable and educational organizations designated by the will of a decedent, which were in existence at the time such income was permanently set aside, and was then reinvested for the estate, falls within the meaning and intent of part of section 219 (b) of the Revenue Act of 1918.[43] . . . .

Therefore the income so permanently set aside, retained, and invested by the executors and trustees is not subject to tax. This does not, however, apply to income set aside for the benefit of an organization not fully in existence, as to which no deduction is authorized.[44] (C. B. 3, page 203; A. R. R. 280.)

The foregoing ruling, which applies to the 1918 law, was evidently based upon a recent case[45] decided by a Circuit Court of Appeals under the laws prior to the 1918 act. The facts in this case were as follows:

DECISION. By his will Alexander J. Derbyshire, who died in 1879, devised his residuary estate to "the contributors to the Pennsylvania Hospital," a corporation of Pennsylvania created for char-

[41] Law, section 219 (d).

[42] Section 214 (a-11) refers to deduction for contributions.

[43] Section 219 (b) of the 1921 law is similar to the like numbered section of the 1918 law.

[44] C. B. 1, page 175; O. D. 278.

[45] *Lederer v. Stockton,* 266 Fed. 676; affirmed U. S. Supreme Court, October 16, 1922, — U. S. —, 67 L. Ed. —, — Sup. Ct. —

itable uses and purposes, and no part of the net income thereof is for the benefit of any private stockholder or individual. The devise was subject to the payment to certain annuitants, all of whom, save one, have died. The residuary estate amounts to several hundred thousand dollars, its annual income is substantially $15,000 and upwards, and the remaining annuity is for a few hundred dollars per year. The construction of the will came before the Supreme Court of Pennsylvania in Biddle's Appeal, 99 Pa. 525, wherein the title to the residuary estate was adjudged vested in the hospital. . . . .

It will thus be seen that, while the residuary estate remains theoretically and for purposes of accounting in the hands of the trustee, it is already in the possession of the hospital in the shape of money loaned on mortgage, and upon such loan the hospital is paying to the trustee only such interest as takes care of administrative charges and the surviving annuity. Under such circumstances, the collector assessed and collected, under protest, from the trustee on June 26, 1917, the sum of $4,273.42, being on the income of the residuary estate for the years 1913, 1914, 1915, and 1916, and on June 11, 1918, an income and excess profit tax of $6,842.02 upon the income of the residuary estate of 1917. It is, of course, apparent the trustee has no financial interest in the residuary payment, and while this large sum is in theory assesssed as a tax on income received by the trustee or the testator's estate, the whole sum is paid at the expense, and from the property, of the hospital. The question, then, in substance and practice, resolves itself into this: Is this hospital liable for income tax? . . . .

The court, in deciding that no tax was due, said:

. . . . From the above, it is clear to us, first, that the United States, the taxing power and real defendant in this case, speaking by its legislative branch in plain language enacted its purpose and will to exempt from taxation the income of "any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual"; second, that the action of the United States by its executive officer, in this case the collector of internal revenue, in assessing and collecting this income tax from the hospital, was not warranted by the taxing statutes; and, third, that it is the duty of the United States, acting by its third agency, the federal courts, to prevent its executive branch from illegally defeating its expressed will in the law enacted by its legislative branch.

The sentence in article 342 of Regulations 62 which provides that "the imposition of the tax is not affected by the fact that an ultimate beneficiary may be a person exempt from

tax" appears to be in conflict with the decision in the foregoing case and with the following ruling:

RULING. A testator bequeathed and devised property to trustees to pay a part of the income therefrom to A during his life. The will provided that upon A's death the rest and residue of the estate, together with any accumulated income, should go to a municipality in perpetual trust to hold the same as a permanent trust estate and fund, the income from which was directed to be used exclusively in the exercise of a normal governmental function.

Held, that the income received by the trustees under the will other than that distributed to the annuitants named in the will is not taxable in the hands of the trustees under the Act of October 3, 1913, the Revenue Act of 1916, as amended, the Revenue Act of 1917, or the Revenue Act of 1918. . . . . (C. B. 5, page 104; Digest O. D. 972.)

When executor is obligated to estate.—

RULING. Amounts paid by an executor of an estate, out of his personal funds in discharge of obligations of the estate, such amounts being credited against the executor's liability for interest to the estate, are nevertheless income to the estate to the extent that they represent interest accrued since the death of the testator on obligations of the executor to the estate. (C. B. 1, page 175; O. D. 51.)

Credits allowed when tax is payable by the fiduciary.—

LAW. Section 219. . . . . (c) . . . . **In such cases [paragraph (1), (2) or (3) of subdivision (a)] the estate or trust shall, for the purpose of the normal tax, be allowed the same credits as are allowed to single persons under section 216.**[46]. . . .

REGULATION. (*a*) An estate or trust taxed to the fiduciary is allowed the same credits against net income as a single person, including a personal exemption of $1,000, but no credit for dependents. (*b*) In the case of an estate or trust taxed to the beneficiaries each beneficiary is allowed for the purpose of the normal tax, in addition to his individual credits, his proportionate share of such dividends as described in Article 301 and of such interest not entirely exempt

[46] The credits so specified in section 216 are: (1) dividends, (2) interest on United States government bonds and bonds of the War Finance Corporation, (3) an exemption of $1,000. See Chapter XXV for determination of taxable Liberty bond interest.

[Former Procedure] The specific exemption allowed to estates under the acts of 1913 and 1916 was $3,000. In 1917, two specific exemptions, one of $3,000 and one of $1,000, were permitted. Under all acts, if the income of the estate or the amount payable to any beneficiary was less than the exemption, no return was required from the fiduciary.

from tax upon obligations of the United States and bonds of the War Finance Corporation as are received by the estate or trust. Each beneficiary is entitled to but one personal exemption, no matter from how many trusts he may receive income. . . . . (Art. 346.)

Credit for taxes.—

LAW. Section 222. (a) That the tax computed under Part II of this title [Income Tax] shall be credited with: . . . .

(4) In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership or the estate or trust paid during the taxable year to a foreign country or to any possession of the United States, as the case may be.[47]

Taxable income when trusts have been established.—If the income from an estate or trust is held for distribution to unborn or unascertained persons or persons with contingent interests and there is no periodic distribution of income, the net taxable income is determined in substantially the same manner as is prescribed for estates in the process of administration. If, however, income is distributed periodically to beneficiaries or part is distributed and part held in trust, the determination of the taxable income of the estate or trust and of the beneficiaries becomes a more difficult problem. Following is the latest Treasury regulation on this subject:

Estates or trusts which cannot be treated as units.[48]—

REGULATION. In the case of an estate or trust, the income of which consists both of income to be distributed to beneficiaries period-

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[47] See Chapter XXXIII for discussion of this credit.

[48] [Former Procedure]

REGULATION. In the case of a trust estate where the terms of the will or trust or the decree of a court of competent jurisdiction provides for keeping the corpus of the estate intact, and where physical property forming a part of the corpus of such estate has suffered depreciation through its employment in business, a deduction from gross income for the purpose of caring for this depreciation, where the deduction is applied or held by the fiduciary for making good such depreciation, may be claimed by the fiduciary in his return of income. Fiduciaries should set forth in connection with their returns the provision of law, trust, or decree requiring such depreciation deduction where any exists or when actual depreciation occurs, the amount thereof, and that the same has been or will be preserved and applied as such. All amounts paid by fiduciaries to

ically and other income, the net income of the estate or trust shall be computed and a return thereof made by the fiduciary in accordance with section 219 (b)[49] and the tax shall be imposed and paid by the fiduciary in accordance with section 219 (c),[50] except that there shall be allowed as an additional deduction in computing the net income of the estate or trust that part of its income of the class described in section 219 (a) (4)[51] which, pursuant to the will or trust deed, is distributable during its taxable year to the beneficiaries. Each of such beneficiaries shall include, in computing his net income, that part of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable to him during the taxable year. (Art. 347.)

An example of the application of the provisions of the foregoing regulation was contained in an amendment to the article of the 1918 regulations dealing with the same subject.

Ruling. . . . . For example, a trust is created the income of which is distributable periodically for the life of the beneficiary, the remainder over to others. The trust has the following items of income. Rent, $3,000; interest, $2,000; gain on sale of capital assets, $1,500; cash dividend, $1,000; and deductions, general expenses (all deductible from distributable income), $700; depreciation, $300; loss on sale of capital assets, $3,000. Under the terms of the trust $5,300 will be distributed to the beneficiary, viz., rent, $3,000; plus interest, $2,000; plus dividend, $1,000; less general expenses, $700. The gain and loss on the sale of capital assets will be considered capital items affecting the corpus only, and the items of depreciation will not affect the amount to be distributed, there being no rule of State law or provision of the trust requiring this deduction from distributable income. In such a case the fiduciary must report on Form 1041 showing a net income for the trust of $3,500, and must show as the distributive share of the beneficiary the $5,300 to which he is entitled. The beneficiary must account for the amount actually distributable to him as income, viz., $5,300, as provided in section 219 (*d*) and will be entitled to a credit of $1,000 on account of the dividends in computing the normal tax, but not to any deduction on account of depreciation or capital losses.

If there had been no loss on the sale of capital assets so that the net income of the estate or trust was $6,500, Form 1041 should

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beneficiaries of trust estates from the income of such trust estates, whether from reserves or otherwise, are held to be distributions of income and will be treated for income-tax purposes in accordance with the provisions of law and regulations applicable to income of such beneficiaries. (Par. 199, Reg. 33; covering the 1916 and 1917 laws.)

[49] See page 1283.

[50] See page 1295.

[51] See page 1276.

show the distributive share of the beneficiary as $5,300, and the distributive share of the fiduciary as $1,200; and the fiduciary should file a separate return on Form 1040 A, reporting $1,200 for taxation. (Reg. 45, Art. 347, added by T. D. 2987; C. B. 2, page 180.)

Treasury Decision 2987 (dated March 1, 1920) was made retroactive to January 1, 1918, and all former rulings inconsistent with it were revoked.

The significant feature of the amended article 347 of Regulations 45, which was issued for the administration of the 1918 law, was the refusal to allow as a deduction by a beneficiary of an estate or trust, any loss, depreciation or depletion sustained by the estate or trust but not deducted from income distributed or distributable to the beneficiary. This regulation by the Treasury Department was not based on any section of the 1918 law which specifically so provided. The 1921 law embodies such a provision, however, which reads as follows:

Law. Section 215. [Items not deductible] . . . . (b) Amounts paid under the laws of any State, Territory, District of Columbia, possession of the United States, or foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time, nor by any deduction allowed by this Act for the purpose of computing the net income of an estate or trust but not allowed under the laws of such State, Territory, District of Columbia, possession of the United States, or foreign country for the purpose of computing the income to which such holder is entitled.

The Treasury regulation pertaining to this section of the 1921 law gives an example of its effect.

Regulation. Amounts paid to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be subject to any deduction for shrinkage (whether called depreciation or any other name) in the value of such interest due to the lapse of time. In other words, the holder of such an interest so acquired may not set up the value of the expected future payments as corpus or principal and claim deductions for shrinkage or exhaustion thereof due to the passage of time.

No deductions shall be allowed in the case of a life or a terminable interest acquired by gift, bequest, or inheritance, where the estate

or trust is entitled to a deduction under the statute but there is no reduction of the income of the life or terminable interest. For example, an estate or a trust in a certain State sells securities at a loss; if, under the laws of that State, the beneficiary suffers no actual loss, then even though the estate or trust is permitted to deduct such loss in making its return, the beneficiary whose income has not been diminished thereby is not entitled to a deduction on account of such loss but must include in his return the full amount distributed or distributable. . . . . (Art. 295.)

Inasmuch as section 215 (b) gives the sanction of law from January 1, 1921, on, to the position previously taken in administering the 1918 law, the following opinion of the Solicitor is in part reproduced.

Rulings. Under section 219 of the Revenue Act of 1918 where an estate or trust represents different interests and is not susceptible of treatment as a unit, the fiduciary, in determining the distributive shares of the beneficiaries, shall analyze the items of gross income and deduction and shall (a) account as fiduciary for income held for future distribution or added to the corpus; (b) assign to the beneficiaries income which is distributable periodically; (c) report on form 1041 the net income of the estate or trust computed as a unit, but show as the distributive shares of the beneficiaries the amounts of income which should be periodically distributed to them (whether distributed or not); (d) report on form 1041 any excess of the net income of the estate or trust over the aggregate distributive shares of the individual beneficiaries as the distributive share of the fiduciary; (e) if such amount exceeds $1,000, make a separate return on form 1040 or 1040-A including such income.

The result of this will be that each beneficiary must include in computing his net income the entire sum which should be periodically distributed to him (whether distributed or not) from the estate or trust as income (other than exempt income) and no more than such sum. (C. B. 2, page 181; Digest O. 1013.)

. . . . The present statute specifies class (3) "Income held for future distribution under the terms of the will or trust" and class (4) "Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals. . . . ." It seems clear that the part of the income which is distributable falls within class (4) and that the part which is accumulated falls within class (3). It is clear that the total amount in question is *income* for which some one should account, and that it would be highly inequitable and unjust to tax the present beneficiary upon income which is not distributable to him and to which he is not beneficially entitled. It is equitable and just, however, that the fiduciary should pay the tax upon income

accumulated for the benefit of the remainder-men, thereby deducting the tax from the amount to be distributed to the remainder-men in the future. It is therefore evident that in this case the two classes of income must be treated differently in spite of the general treatment of estates and trusts as a unit by the statute. . . . . (C. B. 2, page 181; O. 1013; Sec. I.)[52]

Regarding the allocation of capital losses to distributable income, it is argued that such losses are not ordinarily allowable deductions to the life tenant, because such deductions belong to the remainderman and, regardless of whether or not there are capital gains to offset such losses, the life tenant is not equitably entitled to take the losses. Denial of such deductions to the life tenant is deemed to be necessary to protect the interests of the remainderman.

RULING. . . . . Trustees may be induced to make such sales in order to register a loss for the benefit of the life tenant. The remainderman is thus prevented from registering the loss at a later date when his remainder becomes vested in possession, and [he] may be compelled to account for an unduly large gain at some time in the future. . . . (C. B. 2, page 181; O. 1013; Sec. III.)

The reasoning relative to allowance and depreciation to life tenants is stated concisely as follows:

RULING. Items of deduction (according to income tax statute) which are disregarded by the State courts in making distributions, there being no term of the will or trust or rule of law requiring their deduction from distributable income, e. g., depreciation and depletion.

In Law Opinion 456 it was held, under the Revenue Act of 1916 as amended, that the beneficiaries should compute their distributive shares after deduction of depletion. That statute, however, differed from the present one. In Advisory Tax Board recommendation No. 56 a similar ruling was made with reference to depreciation under the Revenue Act of 1918.

These rulings were based upon the literal interpretation of the statute previously discussed and upon the theory that where a will provided for the distribution of income without deduction for depreciation or depletion the beneficiary really received partly income and partly capital. The line of reasoning developed in solving case (III), however, indicates that this result is erroneous. Deductions for depletion and depreciation are deductions designed to restore

[52] See also C. B. 4, page 226; O. D. 808; and C. B. 5, page 190; O. D. 1041.

capital and as such affect the interest of the remainderman and do not affect the distributive share of the life tenant. Probate courts in general disregard depreciation (other than amounts actually expended for repairs) and depletion unless the trust specifically provides that deduction shall be made on that account. The sums received by the beneficiaries in such cases are clearly part of the gross income of the estate or trust and should not be reduced by deductions made to restore capital to which they are not entitled. The answer is the same as the answer to case (III).[53] (C. B. 2, page 181; O. 1013; Sec. IV.)

The Treasury seemed to realize that serious objection would be made to the principles stated in article 347 of Regulations 45.

Ruling. . . . . The principal objection to the answers given to questions (III) and (IV) will be that the construction there adopted may deprive both life tenant and remainderman of the benefit of these deductions for the reason that there will be no income subject to the same treatment in some years from which to deduct them. It is obvious, however, that in many cases a part of the income will be accumulated for future distribution or part of the income will consist of gains from sale of capital assets so that such deduction may be taken. In such cases the equity of the classification of items of gross income and deductions adopted above is emphasized. Such cases will be readily solved by an application of the principles previously stated. The fact that a theoretically correct deduction is not beneficially deducted by anyone is a common occurrence and in no way decisive. The deduction is beneficially allowed if the same interest has a large enough gross income. An individual who has no income loses the benefit of depreciation deductions to which he is entitled. (C. B. 2, page 181; O. 1013; Sec. V.)

Replying to the objection that denial of deduction of capital losses by life tenants is contrary to the express provision of the statute (section 219), which contemplates a computation of the net income of the estate or trust as a unit and for an accounting by the beneficiaries of their distributive share of such net income so computed, and may be interpreted to mean therefore that the aggregate distributing shares of the beneficiaries cannot exceed the net income of the trust or estate computed as a unit, the Treasury says:

[53] Section III of this ruling deals with capital losses.

RULING. This applies a literal interpretation of the statute, but reaches a result which should be avoided if possible since it is contrary to the fundamental rights of the parties and to the spirit and purpose of income taxation in general. (C. B. 2, page 181; O. 1013; Sec. III.)

The above ruling is in keeping with the usual practice of the Treasury in adhering to the literal interpretation of the statute when such interpretation is to the disadvantage of the taxpayer.

How closely the procedure outlined in article 347 of Regulations 45 is to be considered as indicating the intent of the 1918 law as regards estates, trusts and their beneficiaries, remains to be determined, as the courts have not yet passed on the question. The enactment of section 215 (b) of the 1921 law is not necessarily to be deemed to express the intent of the 1918 law. For a discussion of this question, particularly as to the legality of article 347, the reader is referred to pages 1045 and 1046 of *Income Tax Procedure,* 1921.

Taxability of stock dividends received by life-tenants.— When stock dividends are received by life-tenants (as is the case in some states) who do not own the stock upon which the dividends are declared, the Treasury held in a recent ruling that "the value thereof at the date of distribution should be included in the income of the distributees" and "the proceeds from the sale of this stock, or the market value of the stock, can not be regarded as a dividend to the beneficiary subject to surtax only" but "must be treated as income subject to both normal tax and surtax."[54] ". . . . It is further held that for income tax purposes, the time at which the surplus against which these stock dividends were declared or accumulated, namely, whether before or after March 1, 1913, has no bearing upon the treatment of the gain or loss realized or sustained through subsequent sale of the stock representing stock dividends."[55]

It is difficult to decide from the foregoing whether the

[54] I-47-604; I. T. 1506.
[55] I-47-605; I. T. 1507.

life-tenant should or should not be grateful for the stock dividend. Probably not. It is also difficult to decide what kind of income a stock dividend is to a life-tenant if it is not a dividend. The ruling involves questions of state laws, and it may be sound, although the taxation of surplus accumulated prior to March 1, 1913, runs counter to the law. Furthermore it conflicts with the ruling quoted on page 1305.

For computations illustrating results of I. T. 1506, see page 774.

Tax on capital gains.—The "capital gains" provision of the 1921 law is of importance to estates and trusts because of the amelioration of surtax burdens when considerable gains are realized on sales of investments. This subject is discussed at length in Chapter XXII, and the principal question which needs to be specially considered when applying section 206 to estates and trusts is, as to the starting point for the prescribed two-year period during which investments must be held to obtain the benefits of the "capital gains" provision.

As to securities purchased by the fiduciary, the two-year period obviously runs from the date of purchase. As to securities which form a portion of the corpus of the estate or trust at its inception, the author's opinion is that the two-year period runs from the time the estate comes into the hands of the fiduciary or the trust is created.[56] The time during which a testator or the creator of a trust had held securities afterward sold by a fiduciary cannot be considered as being equivalent to ownership by the estate or trust. A decedent's estate or a trust created by an irrevocable deed of trust are entities distinct from the estate of the decedent or the grantor of the trust. Profits or losses on subsequent sales of securities are based, not on the cost thereof to the decedent in his lifetime or to the maker of the trust, but on their values at the time they came into the hands of the fiduciary. Similarly, the

[56] I-27-387; I. T. 1379.

two-year period under the "capital gains" section starts from the time the securities came into the hands of the fiduciary.

Taxable income under profit-sharing plans.—With the growth of various profit-sharing plans, instituted by employers for the benefit of employees, the law now includes a new provision which defines what is taxable income to the distributees under such a plan.

LAW. Section 219. . . . . (f) A trust created by an employer as a part of a stock bonus or profit-sharing plan for the exclusive benefit of some or all of his employees, to which contributions are made by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, shall not be taxable under this section, but the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him. Such distributees shall for the purpose of the normal tax be allowed as credits that part of the amount so distributed or made available as represents the items specified in subdivisions (a) and (b) of section 216.

The question of profit-sharing funds and of the treatment of income derived therefrom is dealt with fully in the chapter on "Income from Personal Services."[57]

The last sentence of section 219 (f) refers to the allowance as credits of the proportionate share of such exempt dividends and interest referred to in section 216 (a) and (b) as may form a part of the earnings received by, or credited to, the distributee.

Personal liability of executor.—Under section 3467, Rev. Stat.,[58] a personal liability for federal taxes attaches to the person of fiduciaries. This liability is referred to in the following regulation:

REGULATION. Liability for payment of the tax attaches to the person of an executor or administrator up to and after his discharge,

[57] Chapter XVII.
[58] See Chapter XLV.

where prior to distribution and discharge he had notice of his tax obligations or failed to exercise due diligence in determining whether or not such obligations existed. Liability for the tax also follows the estate itself, and when by reason of the distribution of the estate and the discharge of the executor or administrator it appears that collection of the tax can not be made from the executor or administrator, the legatees or distributees must account for their proportionate share of the tax due and unpaid. The same considerations apply to other trusts. Where the tax has been paid on the net income of an estate or trust by the fiduciary, such income is free from tax when distributed to the beneficiaries. (Art. 344.)

CHAPTER XLIII

INSURANCE COMPANIES

The problem of taxing insurance companies in an equitable manner has given the Treasury and Congress much concern.[1] The 1921 law,[2] places such companies in a special class. Sections 243-245 define the taxable income of life insurance companies, and sections 246-247[3] define the taxable income of insurance companies other than life or mutual insurance companies. With the exception of those companies which are entirely exempt under section 231 (10), mutual insurance companies are taxable under sections 232-236 which define the taxable income of ordinary corporations. The last named sections, however, contain certain provisions applicable specifically to mutual insurance companies.

Insurance companies defined.—

Regulation. Insurance companies include both stock and mutual companies, as well as mutual benefit insurance companies. A voluntary unincorporated association of employees formed for the purpose of relieving sick and aged members and the dependents of deceased members is an insurance company, whether the fund for such purpose is created wholly by membership dues or partly by contributions from the employer. But a corporation which merely sets aside a fund for the insurance of its employees is not required to file a separate return for such fund if the income and disbursements

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[1] For a brief account of the attempt made in 1918 to establish a new method of taxing insurance companies, see *Income Tax Procedure*, 1922, page 1377.

[2] **[Former Procedure]** In view of the radical changes effected by the 1921 law in the determination of taxable income, no attempt is made in this chapter to give in detail the former procedure with respect to the various items of gross income and deductions. Those who desire to ascertain former procedure are referred to Chapter XXXV of *Income Tax Procedure*, 1921.

[3] Sections 246-247 are effective from January 1, 1922, while sections 243-245 were effective from January 1, 1921. Insurance companies which now are taxable under sections 246-247, were taxed for 1921 under sections 232-236 which define the taxable income of ordinary corporations.

therefrom are included in the corporation's own return. (Art. 1508.)

To facilitate consideration of the law and regulations pertaining to the different classes of insurance companies, this chapter is divided into the following sections:

1. Life Insurance Companies
2. Insurance Companies Other than Life and Mutual Companies
3. Mutual Insurance Companies
4. Exempt Insurance Companies

Life Insurance Companies

Definition of life insurance company.—

LAW. Section 242. That when used in this title the term "life insurance company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds. . . . .

Rates of tax.[4]—

LAW. Section 243. That in lieu of the taxes imposed by sections 230 and 1000 and by Title III, there shall be levied, collected, and paid for the calendar year 1921 and for each taxable year thereafter upon the net income of every life insurance company a tax as follows:

(1) In the case of a domestic life insurance company, the same percentage of its net income as is imposed upon other corporations by section 230;[5]

(2) In the case of a foreign life insurance company, the same percentage of its net income from sources within the United States as is imposed upon the net income of other corporations by section 230.

REGULATION. For the calendar year 1921 and thereafter, life insurance companies, as defined in section 242, shall pay the tax im-

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[4] [Former Procedure] Life insurance companies were not subject to the excess profits tax in 1921, but in prior years were subject to excess profits tax the same as other corporations. Life insurance companies are exempted from capital stock tax under the 1921 law.

[5] Section 230 imposes a tax of 10 per cent on the net income of corporations for the calendar year 1921, and 12½ per cent for succeeding years.

posed by section 243, in lieu of the taxes imposed by sections 230 and 1000 and by Title III of the statute. The rate for 1921 is 10 per cent and for subsequent years 12½ per cent, as in the case of other corporations, but the net income upon which the tax is imposed differs from the net income of other corporations. Insurance companies are entitled to the benefit of section 204 (net losses) but not of section 206 (capital net gain). All provisions of the statute and of these regulations not inconsistent with the specific provisions of sections 242 to 245, inclusive, are applicable to the assessment and collection of this tax, and life insurance companies are subject to the same penalties as provided in the case of returns and payment of income tax by other corporations. In determining whether an insurance company is a "life insurance company" as defined in section 242, no reserve shall be regarded as held for the fulfillment of life insurance and annuity contracts unless the company is entitled to a deduction from gross income on account thereof under the provisions of section 245 (a) (2) and article 681. As to foreign companies see section 245(c) and article 687. (Art. 661.)

Gross income defined.—Life insurance companies include in gross income only the amounts received as interest, dividends, and rents. No part of premiums received from the assured is now to be included in the return.

LAW. Section 244. **(a) That in the case of a life insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents. . . . .**

Net income defined.—

REGULATION. Net income in the case of life insurance companies is gross income from interest, dividends and rents less the deductions allowed by section 245. Gross income comprises items 25–34, inclusive, of the income page of the annual statement for life companies (edition of 1920) adopted by the National Convention of Insurance Commissioners and items 23–30, inclusive, of the income page of the annual statement for miscellaneous stock companies if any other branches of the insurance business are conducted by the company; except that the rental value of the space occupied by the company in its own building or buildings if included in gross income shall be determined according to the provisions of section 245(b) and article 686. As to "reserve funds required by law," see article 681. (Art. 671.)

Deductions.—Deductions are allowed to take into consideration conditions peculiar to insurance companies, particularly conditions imposed by state laws. It will be noted among other things that no deduction is provided by the 1921 law for losses on investments, though on the other hand gains realized from sale of securities are not required to be reported as gross income.

EXEMPT INTEREST.—

LAW. Section 245. **(a) (1) The amount of interest received during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title; . . . .**

The interest referred to includes that on United States obligations and those of states, municipalities, etc. For full treatment of this subject, see Chapters XXIV and XXV.

RESERVE FUND EARNING ALLOWANCE.—

LAW. Section 245. **(a) . . . . (2) An amount equal to the excess, if any, over the deduction specified in paragraph (1) of this subdivision, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, plus (in case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation) 4 per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only; . . . .**

The definition of "reserve funds required by law" is given below:

LAW. Section 244. **. . . . (b) The term "reserve funds required by law" includes, in the case of assessment insurance, sums actually deposited by any company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation of the company or association exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.**

The effect of the deductions referred to in subdivisions (1) and (2) of section 245 (a), is to permit a deduction of 4 per

cent of the year's average reserves required by law, together with 4 per cent of the mean of certain other reserves not required by law at the discretion of the Commissioner.

Regulation. Under paragraphs (1) and (2) of section 245(a), life insurance companies are entitled to deduct from gross income: (1) Interest which is exempted in the case of other taxpayers by section 213(b) (4) and articles 74-83; and (2) the excess, if any, of the reserve deduction specified in section 245 (a) (2) over the amount of such interest. The reserve deduction is based upon the reserves required by express statutory provisions or by the rules and regulations of the State insurance departments when promulgated in the exercise of a power conferred by statute; but such reserves do not include assets required to be held for the ordinary running expenses of the business nor do they include the reserve or net value of risks reinsured in other solvent companies to the extent of the reinsurance. In the case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, it is required that reserves thereon be based upon recognized tables of experience covering disability benefits of the kind contained in policies issued by this particular class of companies. Only reserves peculiar to insurance companies are to be taken into consideration. Reserves "maintained to provide for the ordinary running expenses of a business, definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, reinsurance and unpaid brokerage" (*Maryland Casualty Co. v. United States,* 251 U. S., 342), will not be considered. A company is permitted to make use of the highest aggregate reserve called for by any State in which it transacts business, but the reserve must have been actually held as shown by the annual statement. Generally speaking, the following will be considered reserves as contemplated by the law: Items 7, 8, 9, 10, and 11 of the liability page of the annual statement for life companies,[6] and items 16, 17, 18, 19, and 26 of the liability page of the annual statement for miscellaneous stock companies,[7] if a life insurance company is also transacting other kinds of insurance business. If other reserves are claimed, sufficient information must be filed with the return to enable the Commissioner to determine the validity of the claim. Reference should be made to the item in which the reserve appears in the annual statement and to the State statute or insurance department ruling requiring that such reserves be held. (Art. 681.)

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[6] Treasury Bulletin "H," page 27.
[7] Treasury Bulletin "H," page 47.

Certain dividends deductible.—

Law. Section 245. (a) . . . . (3) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, and other than a corporation organized under the China Trade Act, 1922, or (B) from any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under section 217; . . . .

This deduction is identical with that allowed ordinary corporations under section 234 (a-6).

Dividend reserve earning allowance.—

Law. Section 245. (a) . . . . (4) An amount equal to 2 per centum of any sums held at the end of the taxable year as a reserve for dividends (other than dividends payable during the year following the taxable year) the payment of which is deferred for a period of not less than five years from the date of the policy contract; . . . .

Regulation. The deduction for deferred dividends under section 245 (a) (4) will be based upon item 37[8] of the liability page of the annual statement for life companies but shall not include any dividend payable during the year immediately following the taxable year. (Art. 682.)

Investment expenses.—

Law. Section 245. (a) . . . . (5) Investment expenses paid during the taxable year: *Provided,* That if any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 per centum of the book value of the mean of the invested assets held at the beginning and end of the taxable year; . . . .

Regulation. If any general expenses are in part assigned to or included in the investment expenses, the total investment expenses (other than taxes and expenses with respect to real estate) allowable as a deduction shall not exceed one-quarter of 1 per cent of the mean of the book value of the invested assets held at the beginning and end of the taxable year. If there be no allocation of general

[8] "Amounts set apart, apportioned, previously ascertained, calculated, declared, or held awaiting apportionment upon deferred dividend policies. . . . ."

expenses to investment expenses the deduction may consist of investment expenses actually paid during the taxable year, in which case an itemized schedule of such expenses must be appended to the return. The invested assets are items 1-6, inclusive, item 9, and items 10 and 11 (if interest-bearing assets) of the asset page of the annual statement for life companies, and items 1-4, inclusive, item 7, and items 27-30, inclusive (if interest-bearing assets), of the asset page of the annual statement for miscellaneous stock companies. If the method used by any company in ascertaining the investment expenses where there is any allocation of general expenses shall be changed so that a greater deduction is claimed, the company shall file with its return, information sufficient to enable the Commissioner to determine the validity of the claim. The maximum allowance of one-quarter of 1 per cent will not be granted unless it is shown to the satisfaction of the Commissioner that such allowance is justified. (Art. 683.)

DEPRECIATION.—

LAW. Section 245. **(a) . . . . (7) A reasonable allowance for the exhaustion, wear and tear of property, including a reasonable allowance for obsolescence. In the case of property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913; . . . .**

A limitation is, however, imposed by section 245 (b)[9] on the allowances for depreciation on the properties of life insurance companies.

TAXES AND EXPENSES WITH RESPECT TO REAL ESTATE.—

LAW. Section 245. **(a) . . . . (6) Taxes and other expenses paid during the taxable year exclusively upon or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and not including any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed upon a shareholder or member of a company upon his interest as shareholder or member, which are paid by the company without reimbursement from the shareholder or member, but in such cases no deduction shall be allowed the shareholder or member for the amount of such taxes; . . . .**

This deduction is subject to the proviso contained in section 245 (b) below.

[9] See page 1331.

Regulation. This deduction comprises items 31 and 32 of the disbursement page of the annual statement for life companies and items 34 and 35 of the disbursement page of the annual statement for miscellaneous stock companies, except as noted below, and any sum included in any other item representing taxes imposed upon the individual shareholders' or members' interest in the real estate of the corporation which is paid by the corporation without reimbursement from the individual shareholder or member. In the latter case the amount allowable as a deduction (subject to the provisions of Art. 686) shall be that proportion of the total tax imposed upon the individual shareholders' or members' interest in the corporation which the book value of the real estate owned by the corporation at the end of the taxable year is of the book value of all the corporation's ledger assets, and so much thereof as represents a tax upon real estate occupied in whole or in part by the company must be included in the calculation referred to in article 686. The amount so included shall be that proportion of the total amount allowable as a deduction which the book value of the real estate owned and occupied in whole or in part is of the book value of all the real estate owned. Full details must accompany the return. Any other taxes and expenses (and depreciation) upon any real estate owned and occupied in whole or in part by the company must also be included in the calculation referred to in article 686. Taxes shall not include assessments against local benefits of a kind tending to increase the value of the property assessed and expenses shall not include any amount paid out for buildings or for permanent improvements and betterments made to increase the value of any property. (Art. 684.)

Limitation on deduction for taxes and depreciation.—

Law. Section 245. . . . . **(b) No deduction shall be made under paragraphs (6) and (7) of subdivision (a) on account of any real estate owned and occupied in whole or in part by a life insurance company unless there is included in the return of gross income the rental value of the space so occupied. Such rental value shall be not less than a sum which in addition to any rents received from other tenants shall provide a net income (after deducting taxes, depreciation, and all other expenses) at the rate of 4 per centum per annum of the book value at the end of the taxable year of the real estate so owned or occupied. . . . .**

Regulation. No deduction shall be made for any taxes, expenses, or depreciation on account of any real estate owned and occupied in whole or in part by a life insurance company unless there is included in the return of gross income the rental value of the space so occupied. Such rental value shall not be less than a sum which in addition to any rents received from other tenants shall pro-

vide a net income (after deducting taxes, depreciation, and other expenses) at the rate of 4 per cent per annum of the book value at the end of the taxable year of the real estate so owned and occupied. For example, if the book value of a parcel of real estate owned and occupied in whole or in part by the company is $1,000,000, the rents received from other tenants $30,000, taxes and expenses $40,000, and depreciation $20,000, the company would have to include in its gross income a sum not less than $70,000 ($40,000 taxes and expenses, plus $20,000 depreciation, minus $30,000 rents from tenants, plus 4 per cent of $1,000,000) as the rental value of the space occupied by it in order to avail itself of the deductions of $40,000 and $20,000. In any case the rents received from other tenants must be included in gross income. (Art. 686.)

Interest paid or accrued.—

Law. Section 245. (a). . . . . (8) **All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title; . . . .**

This deduction is identical with that allowed other corporations under section 234 (a-2) with the exception that:

Regulation. . . . . this deduction includes item 18 of the disbursement page of the annual statement of life companies to the extent that interest on dividends held on deposit and surrendered during the taxable year is included therein. . . . . (Art. 685.)

Specific credit.—

Law. Section 245. (a) . . . . (9) **In the case of a domestic life insurance company, the net income of which (computed without the benefit of this paragraph) is $25,000 or less, the sum of $2,000; but if the net income is more than $25,000 the tax imposed by section 243 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000. . . .**

This provision is identical with the corresponding allowance made for income tax purposes to other corporations under section 236 (b). (See Chapter XV.)

Taxable income of foreign company.—The net income of a foreign company subject to United States income tax is ascertained as follows:

Law. Section 245. . . . . (c) In the case of a foreign life insurance company the amount of its net income for any taxable year from sources within the United States shall be the same proportion of its net income for the taxable year from sources within and without the United States, which the reserve funds required by law and held by it at the end of the taxable year upon business transacted within the United States is of the reserve funds held by it at the end of the taxable year upon all business transacted.

Regulation. Foreign life insurance companies holding reserve funds upon business transacted within the United States are taxed under section 243 upon their net income from sources within the United States. All business transacted by a United States branch or agency of a foreign insurance company, for which a reserve fund is required by the laws of any State or Territory of the United States or of the District of Columbia, will be regarded as business transacted within the United States. A foreign life insurance company not doing an insurance business within the United States and holding no reserve funds upon business transacted within the United States, but which derives income from sources within the United States as defined in section 217[10] . . . . is subject to the tax imposed by section 230 upon income derived from sources within the United States. . . . . As to taxation of life insurance companies between United States and Porto Rico and Philippine Islands, see article 1133. (Art. 687.)

Insurance Companies Other than Life and Mutual Companies

Sections 246 and 247 of the 1921 law, which are applicable to this class of insurance companies became effective January 1, 1922.[11]

Rates of tax.—

Law. Section 246. (a) That, in lieu of the taxes imposed by sections 230 and 1000, there shall be levied, collected and paid for the calendar year 1922, and for each taxable year thereafter, upon the net income of every insurance company (other than a life or mutual insurance company) a tax as follows:

(1) In the case of such a domestic insurance company the same percentage of its net income as is imposed upon other corporations by section 230;

[10] See page 1220 *et seq.*

[11] [Former Procedure] Insurance companies in this class were subject to excess profits tax and to capital stock tax for the year 1921. See *Income Tax Procedure*, 1922, page 1387.

(2) In the case of such a foreign insurance company the same percentage of its net income from sources within the United States as is imposed upon the net income of other corporations by section 230. . . . .

The rate provided by section 230 is 12½ per cent.

REGULATION. . . . . For the calendar year 1922 and thereafter, however, in lieu of such taxes, insurance companies, except life and mutual companies, are subject to the tax imposed by section 246. Mutual insurance companies (other than life) remain subject to the taxes imposed by section 230. In articles 691-693 the term "insurance companies" means only those companies subject to the tax imposed by section 246. The rate of the tax imposed by section 246 is the same as the rate imposed by section 230 (12½ per cent), but the net income upon which the tax is imposed, as defined in sections 246 and 247, differs from the net income of other corporations. Insurance companies are entitled to the benefit of section 204 (net losses) but not of section 206 (capital net gain). All provisions of the statute and of these regulations not inconsistent with the specific provisions of sections 246 and 247 are applicable to the assessment and collection of this tax, and insurance companies are subject to the same penalties as provided in the case of returns and payment of income tax by other corporations. Since section 246 provides that the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners shall be the basis for computing gross income and since the annual statement is rendered on the calendar year basis, the first returns under section 246 will be for the taxable year ending December 31, 1922, and will be made on or before March 15, 1923. (Art. 691, as amended by T. D. 3400, dated October 10, 1922.)

Gross income defined.—

LAW. Section 246. . . . . (b) In the case of an insurance company subject to the tax imposed by this section—

(1) The term "gross income" means the combined gross amount, earned during the taxable year, from investment income and from underwriting income as provided in this subdivision, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners; . . . .

INVESTMENT INCOME.—

LAW. Section 246. . . . . (b) . . . . (3) The term "investment income" means the gross amount of income earned during the taxable year from interest, dividends and rents, computed as follows:

To all interest, dividends and rents received during the taxable year, add interest, dividends and rents due and accrued at the end of the taxable year, and deduct all interest, dividends and rents due and accrued at the end of the preceding taxable year; . . . .

Underwriting income.—

Law. Section 246 . . . . (b) . . . . (4) The term "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred. . . . .

Premiums earned.—

Law. Section 246. . . . . (b) . . . . (5) The term "premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance. To the result so obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year; . . . .

Net income defined.—

Law. Section 246. . . . . (b) . . . . (2) The term "net income" means the gross income as defined in paragraph (1) of this subdivision less the deductions allowed by section 247; . . . .

Regulation. Net income is gross income as defined in section 246 less the deductions allowed in section 247. Gross income is the combined gross amount earned during the taxable year from interest, dividends, rents, and premium income, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners. Gross income does not include gain derived from sale or disposition of capital assets, nor are losses sustained from such sale or disposition allowable deductions. It does not include increase in liabilities during the year on account of reinsurance treaties; remittances from home office of a foreign insurance company to United States branch; borrowed money; gross profit on maturity of capital assets; gross increase due to adjustments in book value of capital assets and premium on capital stock sold. The underwriting and investment exhibit is presumed clearly to reflect the true net income of the company, and in so far as it is not inconsistent with the provisions of the statute will be recognized and used as a basis for that purpose. All items of the exhibit, however, do not reflect an insurance company's income as defined in the statute. By reason of

the definition of investment income, profit or loss on investment items is ignored, as well as those miscellaneous items which are intended to reflect surplus but do not properly enter into the computation of income, such as dividends declared, home office remittances and receipts, and special deposits. Gain or loss from agency balances and bills receivable not admitted as assets on the underwriting and investment exhibit will be ignored, excepting only such agency balances and bills receivable as have been charged off the books of the company as bad debts, or having been previously charged off are recovered during the taxable year. (Art. 692.)

Deductions.[12]—The statutory deductions allowed insurance companies other than life and mutual companies are as follows:

Ordinary and necessary expenses.—

Law. Section 247. (a) . . . . (1) **All ordinary and necessary expenses incurred, as provided in paragraph (1) of subdivision (a) of section 234; . . . .**

The deduction is the same as that allowed to other corporations.

Regulation. For the calendar year 1921 insurance companies (other than life insurance companies) are entitled to the same deductions from gross income as other corporations, and also to the deduction of the net addition required by law to be made within the taxable year to reserve funds and of the sums other than dividends paid within the taxable year on policy and annuity contracts. After December 31, 1921, such insurance companies, except mutual companies, are entitled only to the deductions allowed by section 247. . . . . Mutual insurance companies (other than life) are not entitled to the deductions allowed by section 247, but are entitled to the deductions allowed by section 234. . . . . "Paid" includes "accrued" or "incurred" (construed according to the method of accounting upon the basis of which the net income is computed) during the taxable year, but does not include any estimate for losses incurred but not reported during the taxable year. . . . . (Art. 568.)

"Expenses incurred" defined.—

Law. Section 246. . . . . (b) . . . . (7) The term "expenses incurred" means all expenses shown on the annual statement approved

[12] Law. Section 247. "(c) Nothing in this section or in section 246 shall be construed to permit the same item to be twice deducted."

by the National Convention of Insurance Commissioners, and shall be computed as follows:

To all expenses paid during the taxable year add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the net income subject to the tax imposed by this section there shall be deducted from expenses incurred as defined in this paragraph all expenses incurred which are not allowed as deductions by section 247.

INTEREST PAID OR ACCRUED.—

LAW. Section 247. (a) . . . . (2) All interest as provided in paragraph (2) of subdivision (a) of section 234; . . . .

This section allows the deduction of all interest paid or accrued, except that arising from the purchase or carrying of tax-exempt securities (other than original subscriptions to United States obligations issued after September 24th, 1917).

For full treatment see Chapter XXXII.

TAXES PAID OR ACCRUED.—

LAW. Section 247. (a) . . . . (3) Taxes as provided in paragraph (3) of subdivision (a) of section 234; . . . .

REGULATION. . . . . Among the items which may not be deducted are income and profits taxes, paid or accrued, imposed by the United States and so much of the income and profits taxes imposed by any foreign country or possession of the United States as is allowed as a credit under section 238; taxes assessed against local benefits; donations; decrease during the year due to adjustments in book value of capital assets; decrease in liabilities during the year on account of reinsurance treaties; dividends paid to stockholders; remittances to home office of a foreign insurance company by United States branch; and borrowed money repaid. (Art. 693.)

CREDIT FOR TAXES.—

REGULATION. . . . . A domestic insurance company is also entitled to the credit for income, war profits, and excess profits taxes paid during the taxable year to any foreign country or to any possession of the United States which is allowed other domestic corporations by section 238.[13] . . . . (Art. 693.)

For full treatment of the subject of taxes, see Chapter XXXIII.

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[13] See page 884 *et seq.*

LOSSES.—

LAW. Section 247. (a) . . . . (4) Losses incurred; . . . .

"LOSSES INCURRED" DEFINED.—

LAW. Section 246. . . . . (b) . . . . (6) The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year, and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year. To the results so obtained add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year; . . . .

It will be noted that the term "losses incurred" is so narrowly defined that it cannot include losses sustained on investments. On the other hand, as is also true in the case of life insurance companies,[14] the gains from investments, as distinguished from investment income[15] therefrom ("interest dividends and rents") are not required to be included in taxable gross income.

BAD DEBTS.—

LAW. Section 247. (a) . . . . (5) Bad debts in the nature of agency balances and bills receivable ascertained to be worthless and charged off within the taxable year; . . . .

The subject of bad debts is treated at length in Chapter XXXV.

CERTAIN DIVIDENDS DEDUCTIBLE.—

LAW. Section 247. (a) . . . . (6) The amount received as dividends from corporations as provided in paragraph (6) of subdivision (a) of section 234; . . . .

The dividends in question are those received from domestic corporations and from foreign corporations of whose gross income for the preceding three-year period more than 50 per cent was derived from sources within the United States. This subject is dealt with in Chapter XV.

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[14] See page 1327.

[15] Section 246 (b-3).

EXEMPT INTEREST.—

LAW. Section 247. (a) . . . . (7) The amount of interest earned during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title, and the amount of interest allowed as a credit under subdivision (a) of section 236; . . . .

The interest which may be deducted is that from obligations of the United States or its possessions, a state, territory or any political subdivision thereof, or the District of Columbia, also from Farm Loan bonds and bonds issued by the War Finance Corporation. See Chapters XXIV and XXV.

DEPRECIATION.—

LAW. Section 247. (a) . . . . (8) A reasonable allowance, for the exhaustion, wear and tear of property, as provided in paragraph (7) of subdivision (a) of section 234; . . . .

For a full treatment of depreciation, see Chapter XXXVI.

SPECIFIC CREDIT.—

LAW. Section 247. (a) . . . . (9) In the case of such a domestic insurance company, the net income of which (computed without the benefit of this paragraph) is \$25,000 or less, the sum of \$2,000; but if the net income is more than \$25,000 the tax imposed by section 246 shall not exceed the tax which would be payable if the \$2,000 credit were allowed, plus the amount of the net income in excess of \$25,000. . . . .

This provision is identical with that allowed corporations other than insurance companies under section 236 (b). (See Chapter XV.)

Taxable income of foreign company.—The law contains in the case of "insurance companies other than life and mutual insurance companies" no specific direction as to how the gross or net income of foreign companies is to be determined. It is simply stated in section 246 (a-2)[16] that "its net income from sources within the United States" is to be subjected to the same rate of tax as is imposed upon the income of ordinary corporations. It is to be assumed that from the gross income

[16] See page 1334.

from sources within the United States [subject to the definitions of such income contained in section 246 (b)[17]] are to be subtracted the deductions allowed by section 247.[18] These deductions are subject to the following limitation:

LAW. Section 247. . . . . (b) In the case of a foreign corporation the deductions allowed in this section shall be allowed to the extent provided in subdivision (b) of section 234. . . . .

Section 234 (b)[19] limits the deductions of foreign corporations to those "connected with income from sources within the United States."

Mutual Insurance Companies

Mutual insurance companies other than those which are exempt[20] are taxed on a basis similar to that of other corporations, with certain exceptions noted below.[21] Insurance companies taxed on this basis are subject to capital stock tax.

Gross income.—Section 233, in defining gross income for corporations generally, makes applicable thereto the provisions of section 213 (individuals) and section 217 (non-resident alien individuals). The only specific reference to insurance companies is "that mutual marine insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance."

LAW. Section 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in sections 213 and 217, except that mutual marine insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance. . . . .

Section 230 imposes a corporation income tax of 12½ per cent.[22]

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[17] See page 1334 *et seq.*
[18] See page 1336.
[19] See page 1241.
[20] See page 1347.
[21] Sections 246-247; see pages 1333-1340.
[22] For 1921 the rate imposed by section 230 was 10 per cent, the excess profits tax being also in effect during that year.

Regulation. The gross income of mutual insurance companies (other than life) consists of their total revenue from the operation of the business and of their income from all other sources within the taxable year, except as otherwise provided by the statute. Gross income includes net premiums (that is, gross premiums less returned premiums on policies cancelled and premiums on policies not taken), investment income, profits from the sale of assets, and all gains, profits, and income reported to the State insurance departments, except income specifically exempt from tax. Premiums received by mutual marine insurance companies which are paid out for reinsurance should be eliminated from gross income and the payments for reinsurance from disbursements. Deposit premiums on perpetual risks received and returned by mutual fire insurance companies should be treated in the same manner, as no reserve will be recognized covering liability for such deposits. The earnings on such deposits, including such portion, if any, of the deposits as are not returned to the policyholders upon cancellation of the policies, must be included in the gross income. A net decrease in reserve funds required by law within the taxable year must be included in the gross income to the extent that it is released to the general uses of the company and increases its free assets. Any net decrease in reserves shall be added to the gross income, unless the company shall show that such decrease resulted from the application of reserves to the purposes for which they were established. (Art. 549.)

Shipowners' mutual protection and indemnity associations.—If such associations are not organized for profit and no part of the earnings inures to the benefit of any stockholder, they are subject to tax as imposed by section 230, only on net income from interest, dividends, and rents. See page 386.

Deductions allowed.—The deductions allowed mutual companies are those provided in section 234[23] (not those detailed in section 247), with certain additional deductions to meet the special circumstances obtaining in the case of insurance companies.

Additions to reserve funds.—

Law. Section 234. **(a) . . . . (10) In the case of insurance**

[23] See Chapters on Expenses (XXXI), Interest (XXXII), Taxes (XXXIII), Losses (XXXIV), Bad Debts (XXXV), and Depreciation (XXXVI).

companies (other than life insurance companies), in addition to the above (unless otherwise allowed): (A) The net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds); and (B) the sums other than dividends paid within the taxable year on policy and annuity contracts. After December 31, 1921, this subdivision shall apply only to mutual insurance companies other than life insurance companies; . . . .

Regulation. This article applies to all insurance companies (except life) for the calendar year 1921; thereafter it applies only to mutual companies. Insurance companies may deduct from gross income the net addition required by law to be made within the taxable year to reserve funds, including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guaranty or reserve funds. Reserve funds "required by law" include not only reserves required by express statutory provisions but also reserves required by the rules and regulations of State insurance departments when promulgated in the exercise of an appropriate power conferred by statute, but do not include assets required to be held for the ordinary running expenses of the business, such as taxes, salaries, reinsurance, and unpaid brokerage. Only reserves commonly recognized as reserve funds in insurance accounting are to be taken into consideration in computing the net addition to reserve funds required by law. In the case of a fire insurance company the only reserve fund commonly recognized is the "unearned-premium" fund. Casualty companies may deduct losses incurred within the taxable year; but unless the net addition to the unpaid loss reserve required by law exceeds such losses incurred, no deduction for the net addition to the unpaid loss reserve may be taken. In any event only the excess of such net addition over such losses may be deducted. Mutual hail and mutual cyclone insurance companies are entitled to deduct from gross income the net addition which they are required to make to the "guaranty surplus" fund or similar fund. (Art. 569.)

Rulings. The decision of the United States Supreme Court in *Maryland Casualty Company v. United States*[24] does not authorize any insurance company to deviate from the present method of computing the "net addition to reserve funds" deductible from gross income. The amount deductible is the excess of the total reserve funds as required by law at the end of the taxable year over the total of such reserve funds at the beginning of the year regardless of the fact that during the year the reserve funds are increased on account of new business, and decreases in such funds are inevitable

[24] 251 U. S. 342, 64 L. Ed. 297, 40 Sup. Ct. 155.

when policies mature, lapse, or are surrendered. (C. B. 2, page 216; O. D. 427.)

Reserve funds "required by law" include not only reserves required by express statutory provisions, but also reserves required by the rules and regulations of State insurance departments when promulgated in the exercise of an appropriate power conferred by statute, but do not include assets required to be held for the ordinary running expenses of the business, such as taxes, salaries, reinsurance, and unpaid brokerage.

Where there is a net decrease in the reserve funds required to be maintained by an insurance company, so much of the decrease as is released to the general uses of the company and increases its free assets is income to the company.

Any net decrease in reserve shall be added to the gross income, unless the company shall show that such decrease resulted from the application of reserves to the purposes for which they were established. . . . . (C. B. 2, page 216; L. O. 1032.)

Outstanding liabilities for expenses such as salaries should be set up and deducted as such instead of being included in the reserve "required by law."

Ruling. A reserve for the expense of investigating loss claims of an insurance company is not a "reserve" within the meaning of paragraph G (b) of the Act of October 3, 1913, and therefore any net addition thereto may not be deducted in determining net income subject to tax. (C. B. 3, page 276; Digest Sol. Op. 76.)

As stated above, accrued expenses should be deducted as such and not as a "reserve." The deduction, however, is permitted only when taxpayers keep their books on the accrual system. It would appear from the foregoing ruling that the deduction was denied because it was not properly accrued on the books at the time.

In passing on the question of "whether the reserve set up by a fire insurance company against unpaid losses is a reserve within the meaning of the provision . . . . permitting a deduction from gross income in the case of insurance companies, of the 'net addition required by law to be made within the taxable year to reserve funds,' " the Solicitor of Internal Revenue stated[25] that:

[25] C. B. 4, page 297; L. O. 1056.

RULING. The insurance commissioners of the several States require fire insurance companies to return each year as an item of their liabilities the net amount of unpaid losses whether actually adjusted or in process of adjustment or resisted, and it is contended on behalf of such insurance companies that, under the decision of the Supreme Court of the United States in the case of the *Maryland Casualty Company v. United States,* 251 U. S. 342 (T. D. 3013), the amount of this item constitutes a "reserve" within the meaning of the provision of the Revenue Act of 1918 above cited.[26]

The Solicitor further stated, however, that:

It has been repeatedly stated on behalf of the fire insurance companies, and never denied, that their books are kept upon an accrued and incurred basis. It is clear, therefore, that under the law they are entitled to deduct the several items included in unpaid losses as "losses" and to allow them also to include these items in reserves the net additions to which may be deducted from gross income in determining the taxable income of such companies, would be in effect to permit them a double deduction, a result which can not be presumed to have been intended by Congress, and which could only be reached under the compulsion of an express provision of the statute.

It is hardly conceivable that insurance companies would intentionally claim a double deduction for losses. It would appear from the Solicitor's opinion that, while he holds that unpaid losses are not deductible as "reserves," they are deductible as "losses" if a company's books are kept on an accrual basis.

Special deductions in the case of combined life, health and accident policies.—

LAW. Section 234. (a) . . . . (11) In the case of corporations (except those taxed under section 243)[27] issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan continuing for life and not subject to cancellation, in addition to the above, such portion of the net addition (not required by law) made within the taxable year to reserve funds as the Commissioner finds to be required for the protection of the holders of such policies only. This subdivision shall not be in effect after December 31, 1921; . . . .

[26] Section 234 (a-10-a), re-enacted without substantial change in the 1921 law.

[27] Life insurance companies.

REGULATION. Corporations which issue combination policies of life, health, and accident insurance on the weekly premium payment plan, continuing for life and not subject to cancellation, may deduct from gross income only such portion of the net addition not required by law made within the taxable year to reserve funds as is needed for the protection of the holders of such combination policies. In general the net addition to any fund especially maintained for the protection of such policyholders may be deducted. The determination by the company of the need for such addition is subject to review by the Commissioner, and the return of income should be accompanied by a full explanation of the basis upon which such fund and the additions to it are determined. This article does not apply to life insurance companies taxed under section 243 nor to any taxable period after December 31, 1921. (Art. 570.)

After the enactment of the 1918 law, some insurance companies writing policies described in section 234 (a-11) contended that, since no reserve for the purpose was recognized prior to the 1918 law, the entire reserve might now be deducted, including the portion set up prior to 1918. The Solicitor of Internal Revenue, replying to this contention, cited a statement made in a Federal Court case[28] that, "there is no safer or better settled canon of interpretation than that when language is clear and unambiguous it must be held to mean what it plainly expresses, and no room is left for construction," and pointed out that the law specifically provided that the deduction to be allowed is only for "the net addition . . . . made within the taxable year." He further pointed out that the portion of the addition to be allowed as a deduction is by law within the discretion of the Commissioner and that the latter had promulgated a regulation (article 570, Regulations 45) the effect of which was that the maximum deduction is the net addition (not required by law) within the taxable year to reserve funds.

PREMIUM REPAYMENTS BY MUTUAL MARINE INSURANCE COMPANIES.—

LAW. Section 234. (a) . . . . (12) In the case of mutual marine insurance companies, there shall be allowed, in addition to the deductions

[28] *Swarts v. Siegel,* 117 Fed. 13, 18.

allowed in paragraphs (1) to (10) inclusive, and paragraph (14), unless otherwise allowed, amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon such amounts between the ascertainment and the payment thereof; . . . .

REGULATION. Mutual marine insurance companies should include in gross income the gross premiums collected and received by them less amounts paid for reinsurance. . . . . They may deduct from gross income amounts repaid to policyholders on account of premiums previously paid by them, together with the interest actually paid upon such amounts between the date of ascertainment and the date of payment thereof. The remainder of the premiums accordingly form part of the net income of the company, except to the extent that they are subject to the deductions allowed such insurance companies and other corporations. (Art. 571.)

PREMIUM DEPOSITS RETURNED OR RETAINED.—

LAW. Section 234. **(a) . . . . (13) In the case of mutual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, and paragraph (14), unless otherwise allowed, the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves; . . . .**

REGULATION. Mutual insurance companies (other than mutual life and mutual marine insurance companies), which require their members to make premium deposits to provide for losses and expenses, are allowed to deduct from gross income the aggregate amount of premium deposits returned to their policyholders or retained for the payment of losses, expenses, and reinsurance reserves. In determining the amount of premium deposits retained by a mutual fire or mutual casualty insurance company for the payment of losses, expenses, and reinsurance reserves, it will be presumed that losses and expenses have been paid out of earnings and profits other than premiums to the extent of such earnings and profits. If, however, any portion of such amount is applied during the taxable year to the payment of losses, expenses, or reinsurance reserves, for which a separate allowance is taken, then such portion is not deductible; and if any portion of such amount for which an allowance is taken is subsequently applied to the payment of expenses, losses, or reinsurance reserves, then such payment can not be separately deducted. An amount of premium deposits retained for the payment of expenses and losses and the amount of such expenses and losses, may not both be deducted. A company which invests part of the premium deposits so retained

by it in interest-bearing securities may nevertheless deduct such part, but not the interest received on such securities. A mutual fire insurance company which has a guaranty capital is taxed like other mutual fire insurance companies. A stock fire insurance company, operated on the mutual plan to the extent of paying dividends to certain classes of policyholders, may make a return on the same basis as a mutual fire insurance company with respect to its business conducted on the mutual plan. (Art. 572.)

Rulings. In determining the amount of premium deposits retained by a mutual fire or mutual casualty insurance company for the payment of losses, expenses and reinsurance reserves, it is to be presumed that losses and expenses have been paid out of earnings and profits, other than premium, to the extent of such earnings and profits. Office Decision 403 (Bulletin 7-20) overruled. . . . . (C. B. 3, page 279; L. O. 1050.)

The term "premium deposit" as used in section 12 (a) of the Revenue Act of 1916 and section 234 (a) 13 of the Revenue Act of 1918[29] does not necessarily involve in all cases a return to the policyholder of a portion of the unexpended premium. The necessity of such a return depends upon whether a balance remains from the unexpended premium after the retention by the insurance company of an amount reasonably necessary for the payment of losses, expenses, and reinsurance reserves. (C. B. I-1, page 287; Digest Sol. Op. 141.)

Where the members of a mutual fire insurance company are required to deposit with the company promissory notes, guaranteed by a mortgage on the property insured, and assessments based upon the amount of such notes are levied after losses have been sustained, the assessments so made to meet the losses are held not to be premium deposits. (C. B. I-1, page 286; Digest A. R. R. 882.)

Insurance Companies Which Are Exempt

Mutual insurance companies which conform to certain specified requirements are exempt from taxation.

Fraternal beneficiary societies.—See page 50 *et seq.* For latest definition see I-48-619; I. T. 1516.

Mutual insurance companies and like organizations.—

Law. Section 231. . . . . (10) Farmers' or other mutual hail, cyclone or fire insurance companies, mutual ditch or irrigation com-

[29] The same section was substantially re-enacted in the 1921 law.

panies, mutual or cooperative telephone companies, or like organizations of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting expenses; . . . .

Regulation. It is necessary to exemption that the income of the company be derived solely from assessments, dues, and fees collected from members. If income is received from other sources, such as cash premiums or premium deposits, the corporation is not exempt, even though its additional income is tax exempt. Income, however, from sources other than those specified does not prevent exemption where its receipt is a mere incident of the business of the company. Thus the receipt of interest upon a working bank balance, or of the proceeds of the sale of badges, office supplies or equipment, will not defeat the exemption. The same is true of the receipt of interest upon Liberty bonds, where they were purchased as a patriotic duty and were afterwards sold. Where, however, such bonds are bought as a permanent investment, the receipt of the interest destroys the exemption. The receipt of what is in substance an entrance fee, charged by a mutual fire insurance company as a condition of membership, does not render the company taxable, although this fee is called a premium. A farmers' mutual fire and lightning insurance company does not become taxable because it makes advance assessments for the sole purpose of meeting future losses and expenses, where any balance of such assessments remaining at the end of the year is retained to meet losses and expenses in the ensuing year. But the issuance of policies for stipulated cash premiums prevents exemption. A local exchange or association to insure the owners of automobiles against fire, theft, collision, public liability, and property damage is exempt, since it performs functions of the same character as a mutual fire insurance company, and is a like organization within the meaning of the statute. A local reservoir and ditch company may likewise be exempt from tax. An organization doing business on the "interindemnity" or "reciprocal insurance" plan through an attorney in fact subject to direction of an advisory board of policyholders, which requires advance deposits to cover the cost of the insurance and maintains investments or deposits from which substantial income is derived, is not exempt. The exemption does not include a telephone clearing association, whose business is to apportion toll rates between independent telephone companies handling the same calls and whose income consists of compensation paid by such companies and receipts from the sale of form blanks. The phrase "of a purely local character" qualifies all the organizations enumerated in subdivision (10) of section 231. An organization of a "purely local character" is one whose business activities are confined to a particular community, place, or district, irrespective, however, of political subdivisions. The word "purely" intensifies and

limits "local," and indicates a clear intention on the part of Congress to exempt from taxation only such organizations as are entirely and unqualifiedly "local" in their operations. (Art. 521.)

It has been held that a farmers' mutual fire and lightning insurance company does not lose its exempt status by reason of having funds on hand at the end of its taxable year due to additional assessments to meet expenses for the ensuing year.[30]

It has been held that an association, comprised of members brought together without regard to locality or place for the sole purpose of insuring the lives of such members under a business plan which divided the members into "circles" of 1,000 members each, is not a "like organization of a purely local character."[31] In another case[32] it was held that the phrase must be strictly construed, and a health and accident company does not come within its provisions because of the fact that its income consists solely of assessments, dues and fees collected from members for the sole purpose of meeting expenses.

A so-called mutual insurance company was denied the benefit of section 231 (10) because its subscribers made deposits which were returned to them if not needed.[33] The Solicitor held that "assessment implies a payment in which the policy holder has no further right or claim." If the deposits could be termed assessments the company would be exempt. In other words, if strictly mutual the company was not exempt. If only partially mutual it was fully exempt. A most astonishing ruling!

State created mutual liability insurance company not exempt.—The exemption of a mutual liability insurance

[30] C. B. 4, page 270; Sol. Op. 99.

[31] *Bankers' and Planters' Mutual Insurance Assoc. v. Walker,* U. S. Circuit Court of Appeals, Eighth Circuit, 279 Fed. 53. (C. B. I-1, page 259; Ct. D. 26.)

[32] *Commercial Health & Accident Co. v. Pickering,* U. S. District Court, Southern District of Illinois, Southern Division, 281 Fed. 539. (C. B. I-1, page 256; Ct. D. 22.)

[33] I-41-546; A. R. R. 1159.

company created by the act of a state depends upon the nature of the controlling management.

RULING. The funds contemplated by article 84 of Regulations 45[34] are only those managed and controlled directly by the State through State officers, that is to say those funds the management and control of which constitute an activity of the State. A mutual liability insurance company created by an act of the State legislature to provide insurance for employers to cover their liability under the State employers' liability act and workmen's compensation law, which is not so managed and controlled, is not exempt from taxation under section 213 (b) 7, or under any other provision of the Revenue Act of 1918. (C. B. 5, page 105; O. D. 1074.)

RECIPROCAL INDEMNITY EXCHANGE NOT NECESSARILY EXEMPT.—A number of manufacturers incorporated as a reciprocal indemnity exchange to insure their businesses against fire loss, each subscriber depositing a fixed amount to meet losses, and at the end of the period any unexpended balance being returned to the depositors.

This exchange was originally held to be exempt.[35] The earlier decision was, however, overruled.[36]

RULINGS HOLDING CERTAIN CORPORATIONS NOT EXEMPT.—The following corporations have been held by the Treasury not to be exempt under section 231 (3) and (10): an association operated under the lodge system, its charter providing for the union of its members into a grand fraternal beneficiary educational and patriotic society which assessed its members to provide for sick and death benefits, but derived income from subscriptions to a paper which it published as well as from job printing and other sources;[37] a mutual liability insurance company which derived its income from premiums and assessments of its members which were used to defray operating expenses and indemnify policyholders against payments under a workmen's compensation law;[38] a travelers' association pro-

[34] See Reg. 62, Art. 87 which is identical.
[35] C. B. 2, page 210; O. D. 538.
[36] C. B. 4, page 269; O. D. 866.
[37] C. B. 2, page 207; O. D. 508.
[38] C. B. 1, page 206; O. D. 252.

viding for fixed death benefits to the beneficiaries of its members;[39] a mutual irrigating ditch company which derived income from rents for the use of its surplus water;[40] a casualty insurance association organized for the purpose of insuring its members throughout a state which issued policies for stipulated cash premiums.[41]

An association qualified as a "like organization under section 231 (10) but was held not to be of a purely local character" when its business activities were not confined to a particular community, place or district, but covered an entire state.[42]

Returns of Insurance Companies

Regulation. Insurance companies transacting business in the United States or deriving an income from sources therein are required to file returns of income. The return shall be on Form 1120, except that life insurance companies shall make return on Form 1120 L. As an aid in auditing the returns, wherever possible a copy of the report to the State insurance department should be submitted with the return. Otherwise a copy of schedule D, parts 1, 3 and 4, of the report should be attached to the return, showing the Federal, State, and municipal obligations from which the interest omitted from gross income was derived, and a copy of the complete report should be furnished as soon as ready for filing. (Art. 623.)

Net Losses

The provision of the 1921 law[43] whereby taxpayers may deduct net losses resulting from the operation of their regular trade or business from the net income of the succeeding taxable year, and from the second succeeding taxable year, if necessary, extends to all insurance companies.

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[39] C. B. 1, page 206; O. D. 63.
[40] C. B. 1, page 207; O. D. 318.
[41] C. B. 1, page 203; O. 790.
[42] C. B. 1, page 205; O. 792.
[43] Section 204; see page 965 *et seq.*

CHAPTER XLIV

FARMERS

It is now generally recognized that accurate accounting of the income and expenses incident to the business of farming is practicable.[1] It has its peculiar difficulties, admittedly, but the benefit which accrues to the farmer himself as the result of proper accounting, aside from the question of income taxation, is enough to justify it. If experience should show that our farmers are unable or unwilling to keep the books essential to a precise determination of net income, it may become necessary to adopt some rough approximation of income for use as a basis for the tax. In Great Britain a method was devised under which a farmer's taxable income is assumed to have a definite relation to the rental value of the farm.

In at least one respect the farmer stands in a relatively favorable position with respect to the income tax. To the extent that he is not required to return as income that part of his crops which is consumed as food by himself and his family he receives an allowance for living expenses not allowed other classes of taxpayers. Farmers of course are taxable on any gain derived from sale of all or part of their farm property. In such cases the rules applicable to gains arising from sales are applicable.[2]

Under the 1921 law the gain arising from the sale of farms, title to which has not changed within two years, immediately prior to the sale, will be subject to the maximum rate of 12½ per cent imposed upon capital gains. Such crops as form part of the sale should not be included among capital assets.

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[1] For details of a system see the *Magazine of Wall Street* for January 24, 1920, pages 392-3. A bibliography on farm accounting will be found in *Accountant's Index*, 1921, pages 46-53, 787, 788.

[2] See page 563 *et seq.*

Definition of "farm."—

Regulation. . . . . As herein used the term "farm" embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit, and truck farms, also plantations, ranches and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated farmers. . . . . (Art. 38.)

"Gentlemen" farmers.—

Regulations. . . . . A person cultivating or operating a farm for recreation or pleasure, the result of which is a continual loss from year to year, is not regarded as a farmer. . . . . (Art. 38.)

. . . . If an individual owns and operates a farm, in addition to being engaged in another trade, business, or calling, and sustains a loss from such operation of the farm, then the amount of loss sustained may be deducted from gross income received from all sources, provided the farm is not operated for recreation or pleasure. . . . . (Art. 145.)

. . . . If a farm is operated for recreation or pleasure and not on a commercial basis, and if the expenses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deductions. . . . . (Art. 110.)

It may be inferred from the foregoing that if a person makes a profit out of operating a farm he is a farmer.

The Treasury's position is as follows:

Ruling. It is held that where a farm is operated on a basis other than the recognized principles of commercial farming, such a farm is not to be classed as a commercial enterprise, inasmuch as it does not form a part of the owner's business or trade, and until it is placed upon a profit-paying basis the gross receipts are not to be reported under "gross income" and the expenses are not to be claimed as a deduction. (Extract from letter to a taxpayer, February 9, 1920.)

The regulations are quite right in refusing to allow losses unless it can be shown that a farm is operated as if it were a transaction undertaken for profit. If a taxpayer conducts the farm or estate chiefly for recreation or pleasure, and not as he would conduct a business for profit, the loss, if any, is

apparent only. The deficit is a family, personal or living expense. But if a taxpayer in good faith embarks in the farming business and loses money during one or more years, the loss is an allowable deduction under the law, to the same extent that losses are allowable in other businesses.

The question to be decided is whether the farm is being operated as a business or for recreation or pleasure. It is necessary to judge the facts of each case before the point can be settled. In a case that has been given considerable prominence in the press,[3] the court charged the jury as follows:

Decision. That, if the plaintiff was a person cultivating and operating a farm for recreation or pleasure, other than on the recognized principles of commercial farming, then he was not a farmer.

That if the jury find that the plaintiff was the owner of a body of land devoted to agriculture, either to the raising of crops or pasture, for the purpose of selling the products as a business, then they are entitled to find a verdict in favor of plaintiff on this issue.

Business is that which occupies the time, attention and labor of men for the purpose of a livelihood or profit. It is that which is his personal concern, interest or regular occupation.

In deciding the foregoing case the jury found (and the court sustained the finding) that the following constituted a "business" farm:

The Continental Village farm was located in Putnam County, and consisted of 1,300 acres, 900 of woodland and 400 cultivated. The place was equipped with cow barns and there were 40 cows there, and there was evidence of it being a cattle farm. There were no profits upon the farm, although there was reasonable probability of believing that some day there would be.

It was also decided that another farm was maintained for recreation or pleasure:

The Glenclyffe farm consisted of 480 acres, and only 70 were cultivated and the testimony was that there never was a profit or reasonable expectancy of a profit, that the expenses were far in excess of what legitimately would be a farm venture, that the raising of crops was more of a hobby than a business.

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[3] *Stuyvesant Fish v. Roscoe Irwin,* U. S. Dist. Ct., No. Dist. of N. Y., July 29, 1921.

In another case the court held:

Decision. I think, however, that the evidence establishes clearly that Mr. Plant's farm was conducted as a business enterprise and with the expectation that it would eventually become profitable. The mere fact that a heavy loss was incurred in the initial stages of so large an enterprise does not necessarily show the contrary. But, even though this is not so, I do not believe that farming, when engaged in as a regular occupation and in accordance with recognized business principles and practices, is any the less a business within the meaning of the statute, because the person engaging in it is willing to do so without regard to its profitableness, because of the pleasure derived from it.[4]

When an executor operated a decedent's farm prior to disposition thereof, the costs of operation were deductible even though the decedent was not entitled to such deduction.

It could not be held that the executor operated the farm as a hobby or for pleasure. (C. B. 3, page 145; A. R. R. 249.)

Farmers' co-operative associations exempt.—See page 59 *et seq.*

Books of account.—

Ruling. Every taxpayer carrying on the business of producing, manufacturing, purchasing, or selling any commodities or merchandise, except the business of growing and selling products of the soil, shall, for the purpose of determining the amount of income under the Revenue Act of 1921, keep such permanent books of account or records, including inventories, as are necessary to establish the amount of gross income and deductions, credits, and other information required by an income tax return. (Sections 1300 and 1303 of the Revenue Act of 1921.) The taxpayer shall produce such books of account or records for the inspection of revenue officers duly authorized by law to inspect the same at such time and in the manner provided by law. . . . . (I-46-597; T. D. 3408.)

The foregoing is not an extension of the Commissioner's authority but an abridgment. Farmers are specifically exempted. The requirement should have been extended to individuals and partnerships rendering services and to other taxpayers, or should have been omitted entirely.

[4] *Plant v. Walsh,* 280 Fed. 722, U. S. Dist. Ct. Conn. (April 12, 1922).

Under O. 844 (C. B. 1, page 59) farmers who keep books on an accrual basis may make returns accordingly.

Gross income.—

Regulation. A farmer reporting on the basis of receipts and disbursements (in which no inventory to determine profits is used) shall include in his gross income for the taxable year (1) the amount of cash or the value of merchandise or other property received from the sale of live stock and produce which were raised during the taxable year or prior years, (2) the profits from the sale of any live stock or other items which were purchased, and (3) gross income from all other sources. The profit from the sale of live stock or other items which were purchased is to be ascertained by deducting the cost from the sales price in the year in which the sale occurs, except that in the case of the sale of animals purchased as draft or work animals or solely for breeding or dairy purposes and not for resale, the profit shall be the amount of any excess of the sales price over the amount representing the difference between the cost and the depreciation theretofore sustained and allowable as a deduction in computing net income.

In the case of a farmer reporting on the accrual basis (in which an inventory to determine profits is used), his gross profits are ascertained by adding to the inventory value of live stock and products on hand at the end of the year the amount received from the sale of live stock and products, and miscellaneous receipts for hire of teams, machinery, and the like, during the year, and deducting from this sum the inventory value of live stock and products on hand at the beginning of the year and the cost of live stock and products purchased during the year. In such cases all live stock raised or purchased for sale shall be included in the inventory at their proper valuation determined in accordance with the method authorized and adopted for the purpose. Also live stock acquired for draft, breeding, or dairy purposes and not for sale may be included in the inventory, instead of being treated as capital assets subject to depreciation, provided such practice is followed consistently by the taxpayer. In case of the sale of any live stock included in an inventory their cost must not be taken as an additional deduction in the return of income, as such deduction will be reflected in the inventory. . . .

Sale of machinery equipment, etc.—

In every case of the sale of machinery, farm equipment, or other capital assets (which are not to be included in an inventory if one is used to determine profits) any excess over the cost thereof less the amount of depreciation theretofore sustained and allowable

as a deduction in computing net income, shall be included as gross income.

Exchange of produce for merchandise.—
Where farm produce is exchanged for merchandise, groceries, or the like, the market value of the article received in exchange is to be included in gross income.

Rents.—

Rents received in crop shares shall be returned as of the year in which the crop shares are reduced to money or a money equivalent.

Proceeds of insurance.—

Proceeds of insurance, such as hail and fire insurance, on growing crops should be included in gross income to the amount received in cash or its equivalent for the crop injured or destroyed.

Computing income on crop basis.—

If a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may be computed upon the crop basis; but in any such cases the entire cost of producing the crop must be taken as a deduction in the year in which the gross income from the crop is realized.[5] . . . . (Art. 38.)

Expenses deductible.—

Regulation. A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming.

Tools.—

The cost of ordinary tools, of short life or small cost, such as hand tools, including shovels, rakes, etc., may be included.

Feeding and raising live stock.—

The cost of feeding and raising live stock may be treated as an expense deduction, in so far as such cost represents actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. . . . .

Farm machinery and buildings.—

The cost of farm machinery, equipment, and farm buildings represents a capital investment and is not an allowable deduction as an item of expense.

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[5] See also C. B. I-1, page 72; I. T. 1368.

Development expenditures.—

Amounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may be regarded as investments of capital.

Cost of draft or work animals or live stock.—

Amounts expended in purchasing work, breeding or dairy animals are regarded as investments of capital, ...

Cost of automobile not deductible.—

The purchase price of an automobile, even when wholly used in carrying on farming operations, is not deductible, but is regarded as an investment of capital.

Upkeep of automobile may be deductible.—

The cost of gasoline, repairs and upkeep of an automobile if used wholly in the business of farming is deductible as an expense; if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned according to the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to business purposes is deductible as a necessary expense. . . . . (Art. 110.)

Depreciation.—

Regulation. A reasonable allowance for depreciation may be claimed on farm buildings (other than a dwelling occupied by the owner), farm machinery, and other physical property. A reasonable allowance for depreciation may also be claimed on live stock acquired for work, breeding, or dairy purposes, unless they are included in an inventory used to determine profits in accordance with article 38. Such depreciation should be based on the cost and the estimated life of the live stock. If such live stock be included in an inventory no depreciation thereof will be allowed, as the corresponding reduction in their value will be reflected in the inventory. . . . . (Art. 171.)

Depreciation of orchards is based on original cost plus expenditures incurred to bring the trees to the producing age.[6] Obviously the latter expenditures were not currently deductible as expenses.

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[6] C. B. 1, page 130; O. 797.

RULINGS. Receipt is acknowledged of your letter dated February 24, 1920, quoted here as follows: "I have a 20-acre prune orchard of two thousand (2,000) six-year-old trees. Last year, two hundred and fifty (250) of them died from some unavoidable cause. Am I allowed any depreciation on same?"

In reply, you are advised that the loss sustained by the killing of the trees is the cost of the trees killed, and the amount of such loss is deductible from your income for the taxable year 1919. If the orchard had not reached an income producing stage at the time the trees were killed, the cost of the trees would be the initial cost, or fair market value on March 1, 1913, if the trees were acquired prior to that date, plus the capitalized expenditures incurred in bringing them to maturity. In the event the orchard had reached the income producing stage at the time the trees were destroyed, the cost would be the initial cost or fair market value as of March 1, 1913, plus the capitalized expenditures incurred in bringing them to maturity less depreciation sustained.

The basis of computing depreciation is the cost of the trees at the time the orchard has reached an income producing stage, including initial cost and capitalized expenditures incurred in bringing them to maturity, and the rate of depreciation is to be determined by the average life of the trees from the income producing stage under normal conditions. (Letter to C. M. McKinney, Walla Walla, Washington, signed by G. V. Newton, Acting Assistant to the Commissioner, by S. Alexander, Head of Division, dated March, 1920.)

In the case of orchards and vineyards acquired subsequent to March 1, 1913, and later destroyed, any deduction for loss should be confined to the amounts of capital originally invested in the growing trees and in the new nursery stock which was totally destroyed and the amount expended from date of acquirement to date of destruction in an endeavor to bring such trees and stock to an income-producing stage, eliminating all expenditures on account of permanent improvements or on account of trees and vines the growth of which was merely retarded and not entirely destroyed. (C. B. 2, page 127; O. D. 374.)

LOSSES.—

REGULATION. Losses incurred in the operation of farms as business enterprises are deductible from gross income. . . . . (Art. 145.)

ATTORNEY'S FEES DEDUCTIBLE.—

RULING. A tenant at work on the farm of a taxpayer was injured. In defending suit for damages on account of negligence the taxpayer incurred expenses for attorney's fees.

It is held that if the taxpayer was engaged in farming he was

carrying on a trade or business, and that the attorney's fees constituted compensation for personal services actually rendered which is deductible as an ordinary and necessary expense. If the farm was rented, the amount so paid is deductible as a business expense incident to the earning of the rent. (C. B. 5, page 121; O. D. 1117.)

Deterioration or loss by casualty.—

Regulation. . . . . If farm products are held for favorable markets, no deduction on account of shrinkage in weight or physical value or by reason of deterioration in storage shall be allowed, except as such shrinkage may be reflected in an inventory if used to determine profits. The total loss by frost, storm, flood, or fire of a prospective crop is not a deductible loss in computing net income. . . . . (Art. 145.)

However, if the farmer's accounts are kept on the accrual basis, he receives credit, in effect, for the loss of the destroyed crop because it appears in neither sales nor inventory (which enter into the determination of his gross income), while the cost of the crop is included among the deductions. If the accounts are kept on the cash basis, the destroyed crop would not appear among the gross income (sales of produce) but the cost would be allowed as a deduction.

Loss from death of stock raised on farm.—

Regulation. . . . . A farmer engaged in raising and selling stock, cattle, sheep, horses, etc., is not entitled to claim as a loss the value of animals that perish from among those animals that were raised on the farm, except as such loss is reflected in an inventory if used.

Loss from death of stock purchased.—

If live stock has been purchased for any purpose, and afterwards dies from disease, exposure, or injury, or is killed by order of the authorities of a State or the United States, the actual purchase price of such stock, less any depreciation sustained and allowable as a deduction in computing net income, with respect to such perished live stock, and less also any insurance or indemnity recovered, may be deducted as a loss. The actual cost of other property, less depreciation sustained and allowable as a deduction in computing net income, destroyed by order of the authorities of a State or of the United States, may in like manner be claimed as a loss; but if reimbursement is made by a State or the United States in whole or in part on account of stock killed or property destroyed, the amount received

shall be reported as income for the year in which reimbursement is made. The cost of any feed, pasturage, or care which has been deducted as an expense of operation shall not be included as part of the cost of the stock for the purpose of ascertaining the amount of a deductible loss.

INVENTORY METHOD WHEN USED WILL REFLECT LOSS.—

If gross income is ascertained by inventories, no deduction can be made for live stock or products lost during the year, whether purchased for resale or produced on the farm, as such losses will be reflected in the inventory by reducing the amount of live stock or products on hand at the close of the year. . . . . (Art. 145.)

Inventories of livestock raisers and other farmers.—

REGULATION. (1) Farmers may change the basis of their returns from that of receipts and disbursements to that of an inventory basis provided adjustments are made in accordance with one of the two methods outlined in (A) and (B) below. It is optional with the taxpayer which method is used but having elected one method the option so exercised will be binding upon the taxpayer and he will be precluded from filing amended returns upon the basis of the other method.

(A) Opening and closing inventories shall be used for the year in which the change is made. There should be included in the opening inventory all farm products (including live stock) purchased or raised which were on hand at the date of the inventory and there must be submitted with the return for the current taxable year an adjustment sheet for the preceding taxable year based on the inventory method, upon the amount of which adjustment the tax shall be assessed and paid (if any be due) at the rate of tax in effect for that year. Ordinarily an adjustment sheet for the preceding year will be sufficient but if, in the opinion of the Commissioner, such adjustment is not sufficient to clearly reflect income, adjustments for earlier years may be accepted or required. Where it is impossible to render complete inventories for the preceding year or years, the Department will accept estimates which, in its opinion, substantially reflect the income on the inventory basis, for such preceding year or years; but inventories must not include real estate, buildings, permanent improvements or any other assets subject to depreciation.

(B) No adjustment sheets will be required, but the net income for the taxable year in which the change is made must be computed without deducting from the sum of the closing inventory and the sales and other receipts, the inventory of live stock, crops and products at the beginning of the year; provided, however,—

(a) That if any live stock, grain, or other property on hand at the beginning of the taxable year has been purchased and the cost thereof

not charged to expense, only the difference between the cost and the selling price should be reported as income for the year in which sold;

(b) But if the cost of such property has been charged to expense for a previous year, the entire amount received must be reported as income for the year in which sold.

(2) Because of the difficulty of ascertaining actual cost of live stock and other farm products, farmers who render their returns upon an inventory basis may at their option value their inventories for the current taxable year according to the "farm-price method" which provides for the valuation of inventories at market price less cost of marketing. If the use of the "farm-price method" of valuing inventories for any taxable year involves a change in method of pricing inventories from that employed in prior years, the opening inventory for the taxable year in which the change is made should be brought in at the same value as the closing inventory for the preceding taxable year. If such valuation of the opening inventory for the taxable year in which the change is made results in an abnormally large income for that year, there may be submitted with the return for such taxable year an adjustment statement for the preceding year based on the "farm-price method" of valuing inventories, upon the amount of which adjustments the tax, if any be due, shall be assessed and paid at the rate of tax in effect for such preceding year. If an adjustment for the preceding year is not, in the opinion of the commissioner, sufficient to clearly reflect income, adjustment sheets for prior years may be accepted or required.

Where returns have been made in which the taxable net income has been computed upon incomplete inventories, the abnormality should be corrected by submitting with the return for the current taxable year a statement for the preceding year in which such adjustments shall be made as are necessary to bring the closing inventory for the preceding year into agreement with the opening complete inventory for the current taxable year. If necessary to clearly reflect income, similar adjustments may be made as at the beginning of the preceding year or years and the tax, if any be due, shall be assessed at the rate of tax in effect for such year or years.

Treasury Decision 3296[7] is hereby superseded in so far as it is inconsistent with the provisions of this Treasury decision. (Art. 1586, as amended by T. D. 3399, dated October 7, 1922.)[8]

The Treasury makes it as easy as possible for a farmer to change from a cash receipts to an accrual basis. If taxpayers have not taken inventories heretofore, the information required for the years prior to the current year may be supplied by estimating their inventories as of past dates.

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[7] Amends Reg. 45, Arts. 1581-1588.
[8] Also amends Reg. 45, Art. 1586.

Farm price method.—Article 1586[9] permits farmers to use *market* as the basis of inventory (in contrast with *cost or market*). This is apparently the only case in which appreciations would be taxed before realization, excepting when dealers in securities use the "market value" basis of inventorying permitted by article 1585.

Rulings. The purpose of the adjustment sheets required in article 1586, Regulations 45, is properly to allocate over the period from 1917 to date, the net difference in gain or loss due to changing from a cash basis to an inventory basis.

Opening and closing inventories for these years are first ascertained from the best source of information available, and the gross income of each year is adjusted by adding or subtracting, as the case may be, the additional gain or loss due to the difference between the opening and closing inventory in each year. A separate adjustment sheet should be made for each year from 1917 to date, in order that the sheet for each year may be attached to the return for that particular year. The net income is then adjusted conformably, and from this information the tax on each return is recomputed in this office at the rate at which the tax was originally computed. (C. B. 5, page 64; O. D. 1105.)

Florists are not required to use inventories of growing plants for the purpose of calculating their net income for income tax purposes and should not compute the cost of goods sold during the year by using an inventory value of growing plants on hand at the beginning and end of the taxable year. (C. B. 5, page 63; O. D. 995.)

It should be noted that farmers are entitled to the benefit of section 204 of the 1921 law; and if a net loss is sustained in any taxable year, beginning after December 31, 1920, the loss may be applied against the profits of the succeeding year and any excess of such loss may be applied against the profits of the next succeeding year. See page 965 *et seq.*

Use of form 1040F optional.—

Ruling. The use of Form 1040F is optional since it is designed merely to assist farmers in computing their net income. Therefore, it is unnecessary to file same where the taxpayer has made return and paid the taxes due. (C. B. 1, page 71; O. D. 266.)

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[9] See page 1361.

PART V

MISCELLANEOUS TAXES

CHAPTER XLV

FEDERAL ESTATE TAX

This tax, which forms Title IV of the Revenue Act of 1921, bears at least the merit of antiquity as a part of federal taxation, although some authorities think that this source of revenue should be left exclusively to the states. As long ago as 1797 there was imposed, under the Stamp Act of that year, an inheritance tax. This latter act was in force for five years. It was a war measure, as have been all subsequent inheritance tax acts. The Civil War was responsible for the next law of this nature, imposed in 1862, with a life of eight years; while the Spanish-American War produced the act of 1898 which remained in force for four years. Within the last decade appeared the Revenue Act of 1916, Title II of which was termed an "Estate Tax," amended twice in 1917 (March 3 and October 3), and the act of February 24, 1919, (known as the Revenue Act of 1918), the last prior to the one herein discussed.

It will be noticed that the Stamp Act of 1797 imposed an "inheritance tax." This term cannot be used in relation to the existing tax. True, it is a tax on the transfer of property which passes by inheritance, but it is distinctly a tax on the transfer and not on the manner of that transfer. The law, section 401, states that the tax "is hereby imposed on the *transfer* of the net estate . . . ." It further imposes a tax on the transfer of property by will or trust in anticipation of death. It is tentatively assumed that all property transferred within two years prior to death has been transferred to avoid the tax, and the amount of any such property must be included in the return of the gross estate, unless transferred by "a bona fide sale for a fair consideration in

money or money's worth,"[1] or unless any such transfer being made without valuable consideration within two years of decedent's death, can be established not to have been made in contemplation of death. In any case, the property must be described in the return and its value shown therein. The burden of proof regarding the non-inclusion of the value of such property in the gross estate lies with the legal representatives of the decedent. The latter are likewise responsible for the filing of the notice, the return itself,[2] and the payment of the tax.[3]

The tax is computed on the value of the net estate at varying rates and in graduated blocks or brackets. Herein it differs from most of the state taxes of this nature which are based on the several distributive shares of the net estate, different exemptions being allowed according to the status of the beneficiaries in relation to the decedent. In the federal tax the total net estate is taxed, the net amount having been arrived at in accordance with the regulations hereinafter mentioned, less, in the case of resident estates, a single exemption of $50,000. It is obvious, therefore, that resident estates whose net transfer values do not amount to $50,000 are not subject to the estate tax.[4]

The law dealing with the estate tax forms sections 400-411 of the Revenue Act of 1921, which is effective from November 23, 1921. Prior to this date, the 1918 law was in effect. The latest regulations are known as Regulations 63.

Summary of Law

Section 400. Definitions.
Section 401. Rates of tax.
Section 402. Determination of gross estate.
  Property owned by decedent.
  Dower and curtesy.
  Transfers in contemplation of death.

[1] 1921 law, section 402 (c).
[2] 1921 law, section 404.
[3] 1921 law, section 407.
[4] See Reg. 63, Art. 4. See page 1372.

Interest of decedent in joint estate.
Property passing under a power of appointment by will or deed.
Insurance on life of decedent payable to his estate or to individual beneficiaries in excess of $40,000.

Section 403. Determination of net estate (deductions allowable).

Funeral and administration expenses; claims, etc.
Decedent's share in estate of prior decedent taxed within previous five years.
Charitable bequests, etc.
Specific exemption of $50,000 (for residents only).

Sections 404, 405. Returns, by whom and when made.
Sections 406-411. Tax, when due and by whom payable.

Definitions.—The following definitions appearing in section 2, Title I, of the Revenue Act of 1921, are applicable to the estate tax:

"Person" includes partnerships and corporations as well as individuals;
"Corporation" means associations, joint-stock companies, and insurance companies;
"United States" means, in a geographical sense only, the states, the Territories of Alaska and Hawaii, and the District of Columbia.
"Taxpayer" means any person, trust, or estate subject to taxation under this act.

"Executor" is defined as "the executor or administrator of the decedent, or, if there is no executor or administrator, any person in actual or constructive possession of any property of the decedent" (law, section 400).

Rates of Tax.—The rates of tax imposed by the 1921 law are identical with those under the 1918 law. The exemption of $50,000 applies only to residents.

LAW. Section 401. **That, in lieu of the tax imposed by Title IV of the Revenue Act of 1918, a tax equal to the sum of the following percentages of the value of the net estate (determined as provided in section 403) is hereby imposed upon the transfer of the net estate**

of every decedent dying after the passage of this Act, whether a resident or nonresident of the United States:

1 per centum of the amount of the net estate not in excess of $50,000;

2 per centum of the amount by which the net estate exceeds $50,000 and does not exceed $150,000;

3 per centum of the amount by which the net estate exceeds $150,000 and does not exceed $250,000;

4 per centum of the amount by which the net estate exceeds $250,000 and does not exceed $450,000;

6 per centum of the amount by which the net estate exceeds $450,000 and does not exceed $750,000;

8 per centum of the amount by which the net estate exceeds $750,000 and does not exceed $1,000,000;

10 per centum of the amount by which the net estate exceeds $1,000,000 and does not exceed $1,500,000;

12 per centum of the amount by which the net estate exceeds $1,500,000 and does not exceed $2,000,000;

14 per centum of the amount by which the net estate exceeds $2,000,000 and does not exceed $3,000,000;

16 per centum of the amount by which the net estate exceeds $3,000,000 and does not exceed $4,000,000;

18 per centum of the amount by which the net estate exceeds $4,000,000 and does not exceed $5,000,000;

20 per centum of the amount by which the net estate exceeds $5,000,000 and does not exceed $8,000,000;

22 per centum of the amount by which the net estate exceeds $8,000,000 and does not exceed $10,000,000; and

25 per centum of the amount by which the net estate exceeds $10,000,000. . . . .

REGULATION. For the purpose of computing the tax, the net estate is divisible into blocks, each block being taxed at a different and increasing rate. The preceding table gives the amount at the various blocks and the applicable rate of tax under each of the taxing acts. For example, the tax upon the net estate of $1,240,000 of a decedent dying on March 1, 1919, is computed as follows:

Amount of first block	$50,000 at	1 per cent	$500
Amount of second block	100,000 at	2 per cent	2,000
Amount of third block	100,000 at	3 per cent	3,000
Amount of fourth block	200,000 at	4 per cent	8,000
Amount of fifth block	300,000 at	6 per cent	18,000
Amount of sixth block	250,000 at	8 per cent	20,000
Remainder	240,000 at	10 per cent	24,000
Total net estate	$1,240,000	Total tax	$75,500

There is subjoined a table for ascertaining the tax without the detailed computation given above. An illustration of its use is as

TABLE FOR COMPUTING ESTATE TAX

Net estate			1			2			3			4		
			Date of death											
			Sept. 9, 1916, to Mar. 2, 1917, inclusive (Revenue Act of 1916)			Mar. 3, 1917, to Oct. 3, 1917, inclusive (Amendment)			Oct. 4, 1917, to 6:55 P. M., Feb. 24, 1919, inclusive (Revenue Act of 1917)			After 6:55 P. M., Feb. 24, 1919 (Revenue Acts of 1918 and 1921)		
Exceeding	Not Exceeding	Amount of block	Rate (per cent)	Tax	Total	Rate (per cent)	Tax	Total	Rate (per cent)	Tax	Total	Rate (per cent)	Tax	Total
....	$50,000	$50,000	1	$500	$500	1½	$750	$750	2	$1,000	$1,000	1	$500	$500
$50,000	150,000	100,000	2	2,000	2,500	3	3,000	3,750	4	4,000	5,000	2	2,000	2,500
150,000	250,000	100,000	3	3,000	5,500	4½	4,500	8,250	6	6,000	11,000	3	3,000	5,500
250,000	450,000	200,000	4	8,000	13,500	6	12,000	20,250	8	16,000	27,000	4	8,000	13,500
450,000	750,000	300,000	5	15,000	28,500	7½	22,500	42,750	10	30,000	57,000	6	18,000	31,500
750,000	1,000,000	250,000	5	12,500	41,000	7½	18,750	61,500	10	25,000	82,000	8	20,000	51,500
1,000,000	1,500,000	500,000	6	30,000	71,000	9	45,000	106,500	12	60,000	142,000	10	50,000	101,500
1,500,000	2,000,000	500,000	6	30,000	101,000	9	45,000	151,500	12	60,000	202,000	12	60,000	161,500
2,000,000	3,000,000	1,000,000	7	70,000	171,000	10½	105,000	256,500	14	140,000	342,000	14	140,000	301,000
3,000,000	4,000,000	1,000,000	8	80,000	251,000	12	120,000	376,500	16	160,000	502,000	16	160,000	461,500
4,000,000	5,000,000	1,000,000	9	90,000	341,000	13½	135,000	511,500	18	180,000	682,000	18	180,000	641,000
5,000,000	6,000,000	1,000,000	10	100,000	441,000	15	150,000	661,500	20	200,000	882,000	20	200,000	841,000
6,000,000	7,000,000	1,000,000	10	100,000	541,000	15	150,000	811,500	20	200,000	1,082,000	20	200,000	1,041,500
7,000,000	8,000,000	1,000,000	10	100,000	641,000	15	150,000	961,500	20	200,000	1,282,000	20	200,000	1,241,500
8,000,000	9,000,000	1,000,000	10	100,000	741,000	15	150,000	1,111,500	22	220,000	1,502,000	22	220,000	1,461,500
9,000,000	10,000,000	1,000,000	10	100,000	841,000	15	150,000	1,261,500	22	220,000	1,722,000	22	220,000	1,681,500
10,000,000	....	....	10	....	....	15	......	....	25	....	....	25	....	....

follows: The net estate of a decedent dying March 1, 1919, amounts to $1,240,000. By reference to the table it will be seen that the last complete block preceding this amount is $1,000,000, and that the total tax computed on a million dollars under the rates in force amounts to $51,500. Upon the remainder of the net estate, $240,000, the tax is computed at the rate set out in the next following line, or at 10 per cent. The tax on this amount is consequently $24,000. The following result is thus obtained:

Total tax on........................	$1,000,000	$51,500
Tax on	240,000	24,000
Total	$1,240,000	$75,500

(Reg. 63, Art. 8.)

Description of taxable estates.—

Regulation. The tax is imposed upon the transfer of the net estate. The term "net estate" has a distinct meaning in the statute, signifying the difference between the total value of the gross estate and the total of the authorized deductions. One of the deductions authorized in the estate of a resident decedent is the specific sum of $50,000, and consequently there is no net estate where the gross estate does not exceed that amount. No such deduction is authorized in the estate of a nonresident decedent. . . . . (Reg. 63, Art. 4.)

The tax is imposed upon the transfer of the net estate of every person dying in the United States, whether a resident or non-resident, and quite apart from the question of nationality. The following regulation defines "resident" and "non-resident."

Regulation. The statute provides (paragraph (5) of section 2) that the term "United States," when used in a geographical sense, includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia.

A resident is one who, at the time of his death, had his domicile in the United States; or one who was a citizen of the United States at time of death and with respect to whose property any probate or administration proceedings are had in the United States Court for China. (See Sec. 411.) A missionary who, at the time of death, was serving as such under a foreign missionary board of any religious denomination in the United States, will be presumed to have died a resident of the United States, if domiciled therein at the time of his or her commission and departure for such service, and not a nonresident merely by reason of his or her intention to permanently remain in such service. (See Sec. 403(b).) Subject to the foregoing exceptions, and the presumption applying in the case of such missionaries, all other persons are nonresidents.

Except as stated above, and in section 400 of the statute in respect to the exemption accorded on account of military or naval service in the late war, the statute takes no account of the citizenship of the decedent, but prescribes different rules for the estates of residents and nonresidents.

A citizen of the United States is a nonresident if his domicile is in Porto Rico, the Philippine Islands, or other foreign country, whereas a citizen of a foreign country is a resident if his domicile is in the United States. A person acquires a domicile in a place by living here, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal. (Reg. 63, Art. 5.)

A resident is defined above as one who at the time of his death had his domicile in the United States.

No satisfactory, conclusive or general definition of "domicile" can be given. Intention plays a large part, and each case must be decided on its merits.

In the 1921 act the definition of the term "resident" is also extended to citizens regarding whose property any probate or administration proceedings are had in the United States Court for China.[5]

Military exemption.—

LAW. Section 401. . . . . The taxes imposed by this title or by Title II of the Revenue Act of 1916 (as amended by the Act entitled "An Act to provide increased revenue to defray the expenses of the increased appropriations for the Army and Navy and the extensions of fortifications, and for other purposes," approved March 3, 1917) or by Title IX of the Revenue Act of 1917, or by Title IV of the Revenue Act of 1918, shall not apply to the transfer of the net estate of any decedent who has died or may die from injuries received or disease contracted in line of duty while serving in the military or naval forces of the United States in the war against the German Government, or to the transfer of the net estate of any citizen of the United States who has died or may die from injuries received or disease contracted in line of duty while serving in the military or naval forces of any country while associated with the United States in the prosecution of such war, or prior to the entrance therein of the United States, and any tax collected upon such transfer shall be refunded to the estate of such decedent.

[5] Section 411.

The intent of this section is as obvious as it is just. While it includes only those affected by the late World War, it might be well made applicable to any person on active service generally in the military or naval forces. This attitude has been taken in Title II (income tax) in regard to pensions.[6] Doubt might exist as to just what is comprised under the term "military or naval forces of the United States." Help in this direction is given in the following definition:

REGULATION. . . . . The term "military or naval forces of the United States" includes, among other units, the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, and the Navy Nurse Corps, Female; but does not include personnel of the Public Health Service. . . . . (Reg. 63, Art. 9.)

It would appear that relief from taxation under the statutes mentioned is intended to apply merely to persons who had been employed directly by the government in the prosecution of the war, and no mention is made of the large army of non-combatants who, while not directly in government pay, were subject to the risks of death and disease in the service. Included in this latter category might be the Red Cross workers whose duties entailed the same hardships and sufferings as those performed by the Army Nurse Corps, a body specifically mentioned in the regulation quoted above. The distinction is arbitrary and, in practice, might obviously work an injustice to those who helped in the World War. The attitude of the Department in excluding members of the Public Health Service from tax exemption would indicate that the letter, rather than the spirit of the law, governs these exemptions.

REGULATION. . . . . Where decedent died before his discharge from the military or naval forces of the United States, and it is claimed that his death resulted from injuries received or disease contracted in line of duty during the war with Germany, there should be submitted:

(1) In the case of a soldier, a certificate of the Adjutant General of the Army; in the case of a sailor, a certificate of the Surgeon General of the Navy; in the case of a Marine, a certificate of the Commandant of the Marine Corps; and in the case of a person who

[6] Section 213 (b-9).

served in any auxiliary force comprehended within the term "military or naval forces of the United States," a certificate of the proper authority, showing the occurrence of death while in the service, and whether, by the official records, it resulted from injuries received or disease contracted in line of duty during such war.

(2) In the event that the official records do not disclose all the pertinent facts, then affidavits of officers or enlisted men will be considered in connection with such records as to the incurrence of injury or disease in line of duty during such war.

Where the decedent died after discharge from the military or naval forces of the United States, there should be submitted:

(1) Certificate of discharge from the service, or a duly verified copy of such certificate.

(2) Certified copy of public record of death, showing cause of death.

(3) Affidavit or affidavits of the attending physician or physicians, setting forth decedent's medical history while under the treatment of such physician or physicians.

(4) Affidavits of officers or enlisted men or other evidence bearing upon the question whether death resulted from injuries received or disease contracted in line of duty while serving in the military or naval forces of the United States during such war.

Where it is claimed that the decedent, a citizen of the United States who enlisted in the military or naval forces of any country associated with the United States in the prosecution of such war, died from injuries received or disease contracted in line of duty while in such foreign service, as more fully explained in the third paragraph of this article, there shall be submitted:

(1) Evidence showing his citizenship at the time of such enlistment.

(2) A complete copy of the official records of his service in the forces of the foreign country, certified by the custodian thereof.

Where, in any case, it is determined by the Commissioner that the estate is entitled to the exemption, the executor will be notified to that effect, and his duties with respect to the tax will cease. If the evidence submitted in support of the claim is found not to be satisfactory, such further evidence will be called for, or such investigation instituted, as the Commissioner may direct. If it is determined that the estate is not entitled to the exemption, the executor will be required to file return and pay tax in the same manner as executors of other taxable estates. (Reg. 63, Art. 10.)

Claims for refund arising from military exemption.—In view of the fact that the granting of this exemption is retroactive, attention is particularly called to the provisions of article

96 of Regulations 63 which require that claims for the refunding of estate taxes which are alleged to have been collected without legal authority shall be presented to the Commissioner of Internal Revenue within four years next after payment thereof. Such claims must be made on form 843.

Gross Estate—Individual Property

LAW. Section 402. **That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—**

(a) To the extent of the interest therein of the decedent at the time of his death which after his death is subject to the payment of the charges against his estate and the expenses of its administration and is subject to distribution as part of his estate; . . . .

The intention of the lawmakers is to impose the tax upon what may be called the "realizable" value of the estate. Since the use of the word "realizable" might in some cases lead to abuses, the word "value" is used; but it is intended in all cases that the word is to mean the fair or market or reasonable or realizable value in so far as the aggregate net value, as determined, shall yield a tax fair to the government and fair to those upon whom it is imposed. Tax laws must be construed most strictly against the government.[7] This just principle is not of great importance when tax rates are low; but where tax rates reach 25 per cent it would be harsh and inequitable, and would lead to wholesale evasions, if all doubtful questions were decided against taxpayers. Property for which there is no broad and active market must not be overvalued or the tax collected would be in excess of that which is intended. If an item of property were valued at $4,000 when the readily realizable value is $1,000, the actual tax rate would be 100 per cent instead of 25 per cent. These questions will be discussed in detail hereafter. At this point only the general principle is to be noted.

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[7] *Gould v. Gould,* 245 U. S. 151, 38 Sup. Ct. 53, 62 L. Ed. 211.

The two regulations following are very complete and explicit and leave little room for doubt as to the items of property which should, or should not, be included in the gross estate of the decedent.

REGULATIONS. It is designed by the foregoing provision of the statute that there shall be included in the gross estate the value of all property of the decedent whether real or personal, tangible or intangible, the beneficial ownership of which was in the decedent in his lifetime, and which, upon his death, formed his estate.

The test which determines whether the value of a given interest is to be so included, pursuant to the foregoing provision of the statute, is that stated therein which requires that the property, after death, shall be subject to: (1) payment of the charges against the estate, (2) payment of the expenses of administration, and (3) distribution as a part of the estate.

The value of a vested remainder should be included in the gross estate. Nothing should be included, however, on account of a contingent remainder where the contingency does not happen in the lifetime of the decedent, and the interest consequently lapses at his death. Nor should anything be included on account of an interest or an estate limited for the life of the decedent. There should be included, however, the value of an annuity payable to, or an interest or an estate vested in, the decedent for the life of another person who survives him. For rules in valuing such remainders, annuities, and interests or estates *pur autre vie,* see Article 15. (Reg. 63, Art. 11.)

The value of all real property situated in the United States, and owned by the decedent at the date of his death, should be included in the gross estate, whether the decedent was a resident or a nonresident, and whether the property came into the possession and control of the executor or administrator or passed directly to heirs or devisees. The value of real property situated outside the United States should not be included, except as otherwise provided in Articles 55, 56, and 57, where deductions from gross estate are claimed and the decedent was a nonresident. Where the decedent was a resident, the value of all personal property owned by him should be included, wherever situated. Where decedent was a nonresident, the value of so much of his personal property as had its situs in the United States at the time of his death should be included, and the value of his entire gross estate, wherever situated, if deductions are claimed. . . . .

A cemetery lot owned by the decedent is part of his gross estate, but its value is limited to the salable value of such part of it as is not designed for the interment of the decedent or members of his family. Rents and interest which had accrued at the time of the decedent's death, whether then payable or not, and unpaid matured

coupons, should be included. The value of notes or other claims held by the decedent should be included, though they are canceled by his will. . . . . All bonds, whether federal, state, or municipal, and whether or not containing a tax-free covenant, should be included.

Dividends on either common or preferred stock should be included only where declared prior to the decedent's death and not reflected in the market value of the stock on the day of death. Thus dividends, both declared and payable to holders of record on a date prior to the decedent's death, should be included, provided the stock was selling "ex dividend" on the date of death.

Example: A 5 per cent dividend upon stock is declared March 1, payable on April 1 to stockholders of record on March 15. If the death occurred on March 10 and the market value on that day was 90, the value to be returned for both stock and dividend is 90, the dividend being reflected in the market value of the stock. If the death occurred on March 20, the dividend is not reflected in the market value, and must be returned in addition to the market value of the stock on March 20. (Reg. 63, Art. 12.)

Determination of value of property included in gross estate.—From the point of view of those responsible for the filing of estate tax returns, the question of the determination of values is, naturally, the crux of the whole situation. The regulations, full as they are in substance, cannot deal with every contingency that may arise.

Regulation. Property of the decedent should be returned at its market or sale value at the time of the decedent's death. The criterion of such value is the price which a willing buyer will pay to a willing seller for the property in question under the circumstances existing at the date of the decedent's death or within such reasonable period thereafter as would afford proper opportunity for an examination and sale thereof. Neither depreciation nor appreciation in value subsequent to the date of decedent's death is considered. (Reg. 63, Art. 13.)

The legal definition of the word "value" is by no means settled. The word is held to mean one thing in one law and something else in another law. Generally speaking, the government attempts to fix too high a value, and taxpayers fix too low a value, upon the property the value of which is difficult to determine. Some value in between the two is fair.

Real Estate.—

Regulation. (1) Where real property has been sold, the amount received will be taken as its value provided the sale met the conditions laid down in Article 13. Where no sale has been made, the criterion of value is the best price which could have been obtained within a reasonable period of the decedent's death. The property should not be returned at the local assessed value thereof unless such value represents the true market value at the date of decedent's death. All relevant facts and all elements of value should be considered in every case. . . . . (Reg. 63, Art. 14.)

The one consideration in determining values of real estate, and, in fact, of any other item of property to be included in the gross estate of the decedent, is to arrive at a figure acceptable to the examining officer and at the same time to act fairly by the estate. The regulation just cited and article 13 to which it refers, both leave a number of questions which cannot be decided as matters of fact and on which opinions may differ widely. Any one of these might form a basis for controversy and possible revision of the value submitted by the executor. Definition of "reasonable period," proof as to "the price which a willing buyer will pay to a willing seller," establishment of the "best price" which could have been obtained, are all factors which if utilized should be supported by every possible shred of evidence likely to ensure their acceptance. It should be borne in mind that any haphazard estimate of value, or any item included which could not be substantiated by adequate evidence, might lead to the discounting of other facts possibly of vital interest to the taxpayer.

The regulations are not the law. They can only be recognized as indicative of the interpretation of the law by the Bureau of Internal Revenue. They are of undeniable assistance in preparing returns which must satisfy that Bureau. The regulations should be followed in all possible respects. Improper or negligent methods of determining the reported values will be summarily dealt with. Slipshod valuations result in the Commissioner fixing values with an eye, always, to "highest price." Unless determined by bona fide sales, the

fair value of real estate is, at best, a hypothetical proposition. Ordinarily, in the absence of sale the most acceptable method is to establish a value by appraisal conducted by reputable appraisers, and to submit such appraisals (three or more in number) in the form of affidavits.

Stocks and Bonds.—.

Regulation. . . . . (2) The value of stocks and bonds listed upon a stock exchange should be determined by taking the mean between the highest and lowest quoted selling price upon the date of death. If there were no sales on the date of death the value should be determined by taking the mean between the highest and lowest sales upon the nearest date either before or after the date of death if within a reasonable period. If the decedent died on a Sunday or holiday, the transaction of the next previous business day will govern. If the security is listed upon more than one exchange, the records of the principal exchange should be employed. In general, in valuing listed stocks and bonds the executor should observe care to consult accurate records to obtain value as of the date of death.

If the securities are not listed upon an exchange but are dealt in actively by brokers or have an active market, the value should be determined by taking the sale price as of the date of death or of the nearest date thereto if within a reasonable period. Securities which are not dealt in actively enough to establish market value clearly but in which there are occasional transactions should be valued upon the basis of the nearest sales to the date of death, provided such sales were in the normal course of business, between a willing buyer and a willing seller who were trying to make the best bargain possible. Where quotations are obtained from brokers or where evidence as to the sale of securities is obtained from the officers of the issuing companies, the executor is requested to preserve in his files the letters furnishing quotations for inspection when the return is verified by an investigating officer.

Where securities are actively quoted on a bid and asked basis and actual sales are not available, the bid price as of the date of death will be accepted as the value. In the case of corporate and other bonds where there is no active market, the value is to be determined by giving consideration to the soundness of the security, the interest yield, the date of maturity, and any other relevant factors.

Where there is no active market for the stock or securities (whether listed or unlisted) owned by the estate, or where the sales thereof made from time to time are seriously disproportionate in number of shares sold to the holdings of the decedent, and the executor proceeds in good faith promptly and within a reasonable

time to make a bona fide sale or sales of any of such stocks or securities, the amount so realized will be accepted as the value. Sales, however, of only a few shares out of a large holding, or sales made without a real effort to secure the widest market possible, or sales made merely for the purpose of fixing value will not be considered as conclusive.

If in connection with the value of any particular security conditions of sale or ownership are such that the market value determined as indicated above would not afford a proper basis for the valuation of the decedent's securities the Commissioner on final audit will establish the value by considering all other factors relating to the case. In any case where the estate contends that the value as established by the general rules stated above is not the fair market value for the security owned by the decedent on the date of his death, the evidence upon which it bases its contention should be filed with the return.

Stock in corporations where there have been no bona fide sales within a reasonable period of a number of shares fairly comparable to the decedent's holdings should be valued at what a willing buyer would pay to a willing seller, both being fully informed of the financial condition of the company at the date of death.

Where the decedent's holdings are relatively small, a copy of the balance sheet of the corporation nearest to the date of the decedent's death and a statement of the earnings and dividends for the five years preceding death should be submitted in duplicate with the return wherever practicable. Where the decedent's holdings are relatively large and it is practicable to do so, the fullest financial data should be submitted in duplicate with the return, including in particular balance sheets of the corporation for the five years preceding death, a statement of the net earnings and dividends paid by the company over this period or over a sufficient number (either greater or less) of years prior to the decedent's death to demonstrate the normal earning capacity of the corporation, and a summary of the market conditions and future prospects of the company at the date of the decedent's death, together with a statement showing the relation, if any, of the decedent to the actual operation of the company, the effect of his death thereon, and any and all other factors which may have a bearing upon the value of the stock. Where examinations of a company have been made by accountants, engineers, or other technical experts as of or about the date of death, copies of their reports should be filed with the return where they can be obtained without undue trouble or expense to the estate. In general, the estate should show the basis of its return and submit any financial data that will enable the commissioner accurately and intelligently to review the case.

The full value of securities pledged to secure a loan should be

included in the gross estate. If the decedent had a trading account with a broker, all securities belonging to the decedent and held by the broker at the date of death must be included at their market value on that date. Securities purchased on margin for the decedent's account and held by the broker should also be returned at their market value on the date of death. The amount of the decedent's indebtedness to the broker, or other person with whom the securities were pledged, will be allowed as a deduction from the gross estate. (See Art. 39.) . . . . (Reg. 63, Art. 14.)

The foregoing formula may result in the determination of the fair value of stocks or bonds, but in many cases it is unsound and cannot possibly be sustained by the courts. In the case of listed stocks, the quotations or the actual transactions for one day may be misleading. The trend of the market may be up or down and the number of shares sold may be insufficient to fix conclusively the value of any considerable number of shares. If a decedent leaves 100 shares of United States Steel common stock, the formula in the regulation is fair; if the decedent leaves a large number of shares of an inactive stock, the sale of a few hundred shares may only be the starting point in determining the value of the greater number of shares. In the case of a "close corporation," the earnings for the preceding years may be a major factor in arriving at a fair price, but if there is an abnormal period during those years, or if there is a decided trend towards the end of the period, any buyer of the stock would give more weight to the probable earnings or losses following the date of death than to the results of any of the years preceding death.[8]

As an illustration, consider a close corporation in which the estate is interested to the extent of 1,000 shares of 7 per cent non-cumulative preferred stock. A few isolated sales to employees or officers of the corporation have been effected at par. According to the book figures, the excess of liquid assets over liabilities shows a backing behind the preferred stock of $130 per share issued. The dividend has been regu-

[8] For methods of arriving at fair value, see Chapter XLVI, "Capital Stock Tax," particularly comments on a recently decided case, *Central Union Trust Co. v. Edwards, Collector,* 282 Fed. 1008, page 1485.

larly paid. The corporation also has an issue of common stock which is cared for by an excess of assets (exclusive of good-will) over liabilities and after providing for the preferred stock at par, in a sum representing over $83 per share. Earnings for five years averaged 12½ per cent on the common stock after allowing for 7 per cent on the preferred. According to earnings shown by these book figures, the preferred stock of this corporation would be worth at least par. By reason of the fact that the corporation is a "close corporation" and its ramifications are known only to the few directly interested, it would be a matter of considerable difficulty to find a purchaser for the 1,000 shares included in the estate. An intelligent investor would say "at what price can I purchase 7 per cent preferred shares in any well-known and quoted stock in a similar line of business?" By this means he knows he can buy an issue which he is able to dispose of readily and the price of which is regulated by the prevailing supply, demand, and general business conditions. He may find that the average price of such securities is 91. Why should he pay $100 for what he knows nothing about and which he might have some difficulty in disposing of, if necessary, when he can get the same thing for $91 in a form more easily negotiable and the price of which is established on an accepted financial basis. The fundamental principle on which "fair value" is based demands the possibility of a willing buyer and a willing seller. In appraising values of stocks in close corporations strictly in accord with the regulations, it would seem that this principle may very easily be lost sight of and that an arbitrary figure may be established which, on consideration, does not represent a fair value.

Whatever other factors may obtain, it cannot be denied that the stock of a close corporation should never be valued in excess of the fair market price of shares of stock of corporations in a similar line of business according to quotations on the open market. Investigation has proved that the application of this principle shows how little the actual book value

reflects the fair market value of corporation stock generally. A comparison of the market price of stocks of sixty-one corporations with the book value of those same stocks arrived at by reference to the last preceding balance sheets, as published by the best-known authority, revealed that the average book value per share at a certain date was $137.80, whereas the average selling price per share was $75.84. In other words, the selling price represented only 55 per cent of the book value, at or about the date selected.

While 55 per cent cannot be a constant relative factor as between the selling price of stock and its book value, the fact that it was so in the investigation mentioned, conclusively shows how far from being a "fair market value" would be any figure determined solely on a valuation of the corporate assets.

The principle, however, may well be used where circumstances allow of its introduction. The book value of corporations which issue similar stocks, together with the market value thereof, should be listed and the percentage of the latter to the former should be determined. This percentage should then be applied to the book value of the assets under consideration, and the resultant stock value per share should be utilized as the actual value or in support of a value computed under some alternative method.

Generally speaking, it will be found in practice that the valuation of holdings in close corporations presents a problem to be solved by a general review of conditions from without as well as from within. As has been mentioned before, "a revenue law cannot be made elastic enough to deal with unusual problems."[9] Recognizing this fact, the authors of the Revenue Act of 1921, of which the estate tax is Title IV, have, in Title III (sections 327 and 328) inserted relief clauses to cover cases where a literal interpretation of the law relating to the war-profits and excess-profits tax would work evident hardships on the corporation taxpayer. The spirit of compromise

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[9] *Excess Profits Tax Procedure*, 1921, page 338.

here offered might well be used in principle in the valuation of stocks and bonds for estate tax purposes.

While balance sheets of organizations which come under the category of close corporations are called for in substantiation of determined values of their stock, there would appear to be no reason why the component parts of the balance sheets should not have to be appraised as to value. In this event, and in submitting balance sheets in evident support of values arrived at, it would be necessary to show comparative figures depicting "fair value" as against "book value." A piece of real estate held for a number of years will, under normal circumstances, have a different value at the time of the decedent's death from the figure at which it was purchased. In fact, the whole list of items shown in a balance sheet, where such method of determining the value of stock is used, should be subjected to the same scrutiny for worth at the date required as are the items which are comprised in the gross estate itself and upon the same lines as are suggested for them.

Interest in business.—

Regulation. . . . . (3) Care should be taken to arrive at an accurate valuation of any business in which the decedent was interested, whether as partner or proprietor. A fair appraisal as of the date of death should be made of all the assets of the business, tangible and intangible, and the business should be given a net worth equal to the amount which a purchaser, whether an individual or corporation, would be willing to pay therefor at a normal sale in view of the net value of the assets and the demonstrated earning capacity. Special attention should be given to fixing an adequate figure for the value of the good will of the business in all cases where the decedent has not, for a fair consideration in money or money's worth, agreed that his interest therein shall pass at his death to his surviving partner or partners.

In general, the rules stated above relative to the valuation of other property are applicable to the valuation of an interest as proprietor or partner in a business, and all evidence bearing upon such valuation should be submitted with the return, including copies of reports in any case where examinations of a business have been made by accountants, engineers, or other technical experts as of or about the date of decedent's death. . . . . (Reg. 63, Art. 14.)

Comments heretofore made regarding the valuation of real estate, stocks, and bonds apply as well to many other items of property. A careful audit of the accounts of a going business should be made and a detailed financial statement prepared. Each item in the balance sheet should be fairly valued.

Notes, secured and unsecured.—

Regulation. . . . . (4) The value of notes, whether secured or unsecured, will be presumed to be the amount of unpaid principal, plus accrued interest to the date of decedent's death, unless the executor establishes the right to return them at a lower value, or as worthless. To establish such a right it must be shown by satisfactory evidence that the note, either in whole or in part, is uncollectible by reason of the insolvency of the party or parties liable, or for other cause, and that the property, if any, pledged or mortgaged as security is insufficient to satisfy it. . . . . (Reg. 63, Art. 14.)

It will be observed that the above regulation demands the valuation of notes at their face value unless a right to establish a lower value is supported by satisfactory and sufficient evidence. This is a question which depends entirely on circumstances. When the decedent leaves a business in active running order, which is ultimately to be carried on continuously by his successors, the face value of the assets may well be maintained. In instances, however, when a liquidation of all or part of the assets is necessary, unless value has already been determined by sales, the items under this caption should be included in the gross estate at their readily realizable value at the time of death. Reference to the law[10] demands the inclusion "of all property, real or personal, tangible or intangible," at the "value" at the time of death. An interpretation of the law which differentiates as to the meaning of the term "value at time of death" as between the various properties involved, is an erroneous one. The value of bonds which are quoted on the active market is determined primarily by their yield and due date. These quotations are accepted by the Treasury Department in connection with their inclusion

[10] Law, section 402, quoted on page 1376.

in the gross estate. The principle of ready realization being thus established, the same principle should apply to all assets.

CASH ON HAND OR ON DEPOSIT.—

REGULATION. . . . . (5) The amount of cash belonging to the decedent, either in his possession at the date of death or in the possession of another, should be included. Bank accounts should be returned in the amount on deposit to the credit of the decedent at the date of death. If checks then outstanding, given in discharge of bona fide, legal obligations of the decedent, and not as transfers coming within the provisions of section 402 (c), are subsequently honored by the bank and charged to the account, the balance remaining may be returned, provided the payments effected thereby are not claimed as deductions from the gross estate. Interest which the bank agreed to pay upon condition that the money remain on deposit for a period of time which expired subsequent to the decedent's death, should not be included. . . . . (Reg. 63, Art. 14.)

PATENTS, TRADE-MARKS, AND COPYRIGHTS.—

REGULATION. . . . . (6) The basis for valuation of an intangible asset of this character is the present worth of the estimated future earnings of the exclusive right during the rest of its existence. The return received by the decedent should be considered in estimating future earnings. (Reg. 63, Art. 14.)

The formula laid down in the foregoing regulation regarding the value of goodwill is sound in all cases when goodwill is the subject of sale. When an active partner dies, the value of goodwill is usually overestimated. The greater the personal interest of a decedent in a going business, the less the goodwill is worth.

The latter part of the regulation is not clear. Frequently goodwill under partnership agreements passes to the surviving partners without valuation. In such cases the decedent has divested himself of any interest in the goodwill and it is difficult to see the importance of ascertaining the value which he might have obtained for it if the partnership agreement had provided otherwise. The profit a man might, but does not realize is hardly taxable as property at his death. Of course if, in contemplation of death, a transfer of valuable goodwill should be made within two years before a decedent's

death, the transaction would be open to question, as would be any other transfer similarly made.

The following digest of a memorandum issued by the Committee on Appeals and Review[11] indicates the methods of computation of goodwill values acceptable to the Bureau of Internal Revenue.

BRANDS. Take price at which article under specific brand name sold as against similar article with no brand name. Difference multiplied by number of units sold during given period equals profits attributable to use of brand name. Do this for a sufficient number of years to give a constant figure and capitalize result at 20 per cent.

BRANDS OR GOODWILL, ETC. (1) Take known cash price at which goodwill, or brand, etc., may have been sold. Compare business done by vendor with business done by concern under review. A proportionate value can thus be established.

(2) Take average earnings for five years, apply 10 per cent of this to net tangible assets and apply residue, at five years' purchase, to goodwill.

In case of a business not subject to fluctuations or manufacturing article of daily necessity, reduce return on tangibles to 8 or 9 per cent and capitalize residue for goodwill at 15 per cent instead of 20 per cent.

Representative periods should be used in arriving at adjustments. Years showing extraordinary factors to be eliminated. In capitalizing earnings, percentage shown by the return on actual cost of the business should be considered. If earnings at one of the figures suggested above is in excess of such percentage, the smaller figure should be used.

This memorandum was further supplemented[12] by the suggestion that in determining net earnings under the third paragraph above, a reasonable amount on account of salaries for owners actively engaged in the business be deducted.

The formula set forth in article 14 on page 1387 is sound when applied to the valuation of patents. It is not the same as the formula prescribed by the Income Tax Unit of the Bureau of Internal Revenue for the valuation of goodwill (summarized above). As is the case with stocks of close corporations and goodwill, prospective buyers always attach much

[11] Method of obtaining value of intangible assets, C. B. 2, page 31; A. R. M. 34.

[12] C. B. 4, page 43; O. D. 937.

importance to the probable future earnings of the properties they buy.

Accounts receivable, claims, judgments, etc.—

Regulation. . . . . (7) A fair valuation for assets of this character at the time of death should be fixed by the executor according to the best information available to him at the time of making return. A right of action which terminated with the death of the decedent should not be included in the gross estate. (Reg. 63, Art. 14.)

Accounts receivable should be valued either on the basis of a going business or of a business in liquidation. If the business is being continued and periodical audit reports are available, there is little need to go behind the book value. Should the contrary be the case, a verification of the accounts should be made by direct correspondence with the debtors where necessary, and every care should be exercised in the determination of their collectibility or otherwise. Claims or judgments should not be accepted at face value without due scrutiny as to age and possible collectibility.

Household and personal effects—general provisions.—

Regulation. . . . . (9) Executors and administrators are required to have careful appraisal made of all household and personal effects of the decedent by one or more competent and disinterested appraisers, except as otherwise provided in subdivision (*a*) of this paragraph, and the appraisal thereof, reduced to writing and verified by the oath or oaths of the appraiser or appraisers, should be filed in duplicate with the return on Form 706, accompanied by the affidavit in duplicate of the executor as to the completeness of the itemized lists of such property and of the disinterested character and qualifications of the appraiser or appraisers. Where it is desired to effect distribution or sale of any portion of such property in advance of an investigation by a special officer of the Bureau of Internal Revenue, as provided in Article 72, notice thereof should be given to the Internal Revenue Agent in Charge for the Division wherein the decedent was domiciled at the date of his death, or, if such household and personal effects be not located in such Division, then to the Commissioner. If the return has not been filed, the notice should be accompanied by a verified appraisal of such property, and

an affidavit of the executor as provided above. If personal inspection by a special officer of the Bureau is not deemed necessary, the executor will be so advised. This procedure is designed to facilitate disposition of such property and to obviate future expense and inconvenience to the estate by affording the Commissioner an opportunity to make an investigation, should one be deemed necessary prior to the sale or distribution. . . .

(*a*) When the value of the personalty involved is less than $2,000, the detailed lists may be prepared by the executor personally. A room by room appraisal is desirable; and all the articles should be named specifically, except those of small value, such as common bric-a-brac or cheap books. A separate value should be given for each article named, except that the values of a number of articles contained in the same room may be grouped. The value of an article worth more than $50 should be stated separately. Such an entry as the following would be acceptable:

Dining room: Table, six chairs, three pictures (common prints), value $75; sideboard, $60; total, $135.

If there should be included in the lot, however, jewelry or silverware of more than ordinary value, or articles having a marked artistic value, the executor must furnish an appraisal by a person or persons thoroughly qualified by training and experience to judge of the value of such articles.

In the case of effects having a total value of less than $2,000, the executor may furnish, as an alternative requirement, a sworn statement in duplicate of the aggregate total value of the property by a professional appraiser or appraisers of recognized standing and ability, or by a dealer or dealers in the class of personalty involved.

(*b*) When the value of the effects is more than $2,000, detailed lists must be furnished, prepared by an appraiser or appraisers of recognized competence, or by a dealer or dealers in the particular classes of personalty involved. The lists must be prepared in the same detail as that indicated above for the executor's list. Where the personalty includes jewelery, silverware, or like articles, except in cases where the value of these items is insignificant, the appraisal of a reputable dealer or appraiser of jewelry must be furnished.

In the case of articles having marked artistic value, such as paintings, engravings, etchings, statuary, vases, oriental rugs, or antiques, the appraisal of an expert or experts will be required. A description of such articles should be fully given. Where paintings having artistic value are listed, the size, subject, and artist's name should be stated. In the case of oriental rugs, the size, make, and general condition should be given. The weight in ounces of silverware should be stated.

(*c*) Where expert appraisers are to be employed, care should be taken to see that they are men of recognized competence with respect

to the particular class of property involved. In order to facilitate the acceptance of the appraisal, appraisers should be employed whose competence is well established.

The value to be arrived at in appraising articles of this character is the fair market value on date of decedent's death. Where property is valued by legatees for purposes of distribution, such value will not necessarily be accepted. The original cost of the articles is not necessarily a proper basis, on account of depreciation or appreciation in value. (Reg. 63, Art. 14.)

Cases have arisen where appraisers whose competence was unquestionable have been employed on valuations; yet the Treasury has refused to accept their valuations, although such valuations were accepted by the surrogate's court of the state in question and by the state tax commission.

The Treasury should initiate some procedure whereby co-operation with the appraisers appointed by the surrogate's court would be possible, thereby eliminating duplications which result in disagreements as to the proper values. If such was the case it would not be necessary to give notice to the internal revenue agent before distribution or sale is made.

The foregoing regulation is not unreasonable if executors are not unduly hampered in making distributions or sales. The law is silent on this point and no penalty is imposed. In practice distribution should be supervised in such a way as to satisfy the Treasury that the full value of the estate is reported for taxation.

The valuation of such miscellaneous property, in excess of $2,000, as may come under subdivision (b) of the foregoing regulation is purely a matter of expert appraisal.

A point that requires particular attention in the valuation of household effects is to differentiate between property of this description owned by a surviving husband or wife individually, and that owned by the decedent.

Ruling. Household effects and like personalty used by husband and wife in the marriage relation are presumed to be the property of the husband, and, in the absence of sufficient evidence to rebut this presumption, must be returned as portion of his gross estate.[13]

[13] T. D. 2529.

It is pointed out by the Commissioner that a bare statement from the wife claiming the property is not sufficient; the burden of establishing the claim is thrown upon her. When the wife owned articles of household furniture before marriage, purchased them out of her separate funds or received them as gifts from others, if her claim is supported by proven evidence, such effects need not be included in the gross estate of the husband. The Commissioner further says:[14]

RULING. The following proposition has been announced by the courts and is believed by this office to be sound. To constitute a valid gift there must be an absolute transfer of the property from donor to donee, taking effect immediately and fully executed by a delivery of the property to the donee, and the acceptance thereof by the donee. It is essential that the transaction should be fully executed by the delivery of the property to the donee, or to some person for him. In several States, statutes have been enacted providing that no gift, except by deed or will, shall be valid unless actual possession shall come to and remain with the donee, or his agent, and if the donee or donor reside together at the time of the gift, possession by the donee at their place of residence is not a sufficient possession within the meaning of statute.

Particular care is needed in arriving at the value of growing crops. The knowledge of subsequent realization, most probably available by the time the executor is making up the return, may unduly influence the ultimate determination of the value of the growing crop at the time of decedent's death. Particularly is this the case should the market fall below anticipated figures and so make the valuation appear too high. The appraisal must be made and based entirely on conditions and estimates obtaining *at the date of death* and values fixed in accord therewith, or, if possible, on the basis of sales of similar standing crops effected at that time. All charges necessary to the harvesting and marketing may be deducted from an appraisal based on an estimated worth. When the appraisal is made on comparative figures based on sales of similar standing crops, these costs will not generally be deductible. Such

[14] T. D. 2529.

a sale is usually conditional on the vendee removing and marketing the ultimate crop.

If custom supports the procedure—as, for instance, in tobacco farming, where the aggregate cost of sowing, tending, harvesting, and depositing under cover (but not including picking and sorting) is considered the inventory figure of the year's crop—the value of the standing crop could very easily be estimated. The value at any given date would be the cost up to that date. In any case, and under whatever circumstances the valuation of a ground crop is determined, such valuation should be supported by affidavits from responsible people in the same line of business testifying that the method employed is in accord with prevailing customs in the trade and that the result so obtained fairly represents the value of the crop included in the gross estate.

Other property.—

Regulations. . . . . (8) With respect to all other property, excepting household and personal effects, concerning which see paragraph (9) of this article, the executor should ascertain and return the fair market value thereof as of the day of decedent's death. As to property sold subsequent to death, see Article 13. Live stock, farm machinery, harvested and growing crops, where of an aggregate value of $2,000 or more, should be valued, as of the date of decedent's death, by one or more competent and disinterested appraisers, and their itemized appraisal thereof in writing, verified by the oath of each, should be filed in duplicate with the return on Form 706. The executor should also file in duplicate with the return his affidavit as to the completeness of the itemized lists of such property and of the disinterested character and qualifications of the appraiser or appraisers. (Reg. 63, Art. 14.)

Valuation of annuities and of life and remainder interest.—

Regulation. Where the decedent was entitled to receive an annuity of a definite amount during the lifetime of another person, its present worth at the time of the decedent's death must be computed upon the basis of the expectancy of life of the other person. The table marked "A," a part of this article, should be used for this computation. The amount payable annually should be multiplied by the

figure in column 2 of the table opposite the number of years in column 1 nearest to the actual age of the other person.

Example: The decedent received under the terms of his father's will an annuity of $10,000 for the life of his elder brother. The brother at the decedent's death was 40 years 8 months old. By reference to the table the figure in column 2 opposite 41 years, the number nearest to the brother's age, is found to be 14.86102. The present worth of the annuity is therefore $148,610.20.

Where the decedent was entitled to receive the annuity during a specified number of years, the table marked "B," a part of this article, should be used.

Example: The decedent received under the terms of his father's will an annuity of $10,000 for a period of 20 years, 15 of which had expired at the decedent's death. By reference to the table it is found that the figure in column 2 opposite 5 years, the unexpired portion of the 20-year period, is 4.45182. The present worth of the annuity is, therefore, $44,518.20 (4.45182 multiplied by 10,000).

Where the decedent was entitled to receive the entire income of certain property during the life of another person, or for a term of years, and the annual rate of income for a period equal to or exceeding the life expectancy of such other person or such term of years, is fixed or definitely determinable at the time of the decedent's death, then the present worth of decedent's right to such income should be computed as explained above in the case of an annuity.

Example: The decedent's father placed $100,000 in trust, with directions that it be invested in state and municipal bonds and the entire income paid to the decedent during the life of his elder brother, who was 41 years old at the decedent's death. Before the decedent's death the money was invested in state and municipal bonds maturing at dates beyond such elder brother's life expectancy, and yielding annually an income of $5,000. In this case the rate of income is definitely determinable. By reference to the table, it is found that the present worth of an income of $5,000, dependent upon the life of a person 41 years of age, is $74,305.10 (14.86102 multiplied by 5,000).

Where the rate of annual income is not determinable, or where the decedent was entitled merely to the personal use of nonincome-bearing property, a hypothetical annuity at a rate of 4 per cent of the value of the property should be made the basis of the calculation.

Example: The decedent died before a fund of $100,000, of which he was entitled to receive the income during the life of a person 41 years old, had been invested by the trustees. The value of a hypothetical annuity of $4,000, dependent upon the life of such a person, is indicated by the table to be $59,444.08 (14.86102 multiplied by 4,000).

Where the decedent had a remainder interest in property subject to the life estate of another, and such interest constituted an asset

Table A.

Table, single life, 4 per cent, showing the present worth of an annuity, or life interest, and of a reversionary interest.

1 Age.	2 Annuity, or present value of $1 due at the end of each year during the life of a person of specified age.	3 Reversion, or present value of $1 due at the end of the year of death of a person of specified age.	1 Age.	2 Annuity, or present value of $1 due at the end of each year during the life of a person of specified age.	3 Reversion, or present value of $1 due at the end of the year of death of a person of specified age.
	Annuity.	*Reversion.*		*Annuity.*	*Reversion.*
0	$14.72829	$0.39507	51	$12.17919	$0.49311
1	17.30771	.29586	52	11.88408	.50446
2	18.69578	.24247	53	11.58531	.51595
3	19.15901	.22465	54	11.28325	.52757
4	19.41226	.21491	55	10.97789	.53931
5	19.55301	.20950	56	10.60982	.55116
6	19.61731	.20703	57	10.35931	.56310
7	19.62502	.20673	58	10.04630	.57514
8	19.61097	.20727	59	9.73131	.58726
9	19.53413	.21022	60	9.41474	.59943
10	19.45359	.21332	61	9.09765	.61163
11	19.36943	.21656	62	8.78052	.62383
12	19.28184	.21993	63	8.46412	.63600
13	19.19065	.22344	64	8.14888	.64812
14	19.09590	.22708	65	7.83552	.66017
15	18.99764	.23086	66	7.52476	.67212
16	18.89569	.23478	67	7.21699	.68397
17	18.79010	.23884	68	6.91298	.69565
18	18.68070	.24305	69	6.61301	.70719
19	18.56751	.24740	70	6.31716	.71857
20	18.45038	.25191	71	6.02612	.72976
21	18.32932	.25656	72	5.74003	.74077
22	18.20416	.26138	73	5.45928	.75157
23	18.07471	.26636	74	5.18402	.76215
24	17.94097	.27150	75	4.91463	.77251
25	17.80274	.27682	76	4.65125	.78264
26	17.65984	.28231	77	4.39383	.79254
27	17.51224	.28799	78	4.14286	.80220
28	17.35968	.29386	79	3.89858	.81159
29	17.20225	.29991	80	3.66071	.82074
30	17.03961	.30617	81	3.42900	.82965
31	16.87176	.31262	82	3.20258	.83836
32	16.69846	.31929	83	2.98024	.84691
33	16.51964	.32617	84	2.76106	.85534
34	16.33503	.33327	85	2.54366	.86371
35	16.14437	.34060	86	2.32795	.87200
36	15.94755	.34817	87	2.11384	.88024
37	15.74427	.35599	88	1.90115	.88842
38	15.53421	.36407	89	1.69107	.89650
39	15.31722	.37241	90	1.48540	.90441
40	15.09295	.38104	91	1.28432	.91214
41	14.86102	.38996	92	1.09024	.91961
42	14.62122	.39918	93	.90647	.92667
43	14.37356	.40871	94	.73687	.93320
44	14.11860	.41852	95	.58435	.93906
45	13.85713	.42857	96	.46182	.94378
46	13.58958	.43886	97	.36698	.94742
47	13.31698	.44935	98	.24038	.95229
48	13.03942	.46002	99	.00000	.96154
49	12.75716	.47088			
50	12.47032	.48191			

TABLE B.

1 Number of years.	2 Present worth of an annuity of $1, payable at the end of each year, for a certain number of years.	3 Present worth of $1, payable at the end of a certain number of years.	1 Number of years.	2 Present worth of an annuity of $1, payable at the end of each year, for a certain number of years.	3 Present worth of $1, payable at the end of a certain number of years.
	Annuity.	*Reversion.*		*Annuity.*	*Reversion.*
1	$0.96154	$0.961538	16	$11.65229	$0.533908
2	1.88609	.924556	17	12.16567	.513373
3	2.77509	.888996	18	12.65929	.493628
4	3.62989	.854804	19	13.13394	.474642
5	4.45182	.821927	20	13.59032	.456387
6	5.24214	.790314	21	14.02916	.438834
7	6.00205	.759918	22	14.45111	.421955
8	6.73274	.730690	23	14.85684	.405726
9	7.43533	.702587	24	15.24696	.390121
10	8.11089	.675564	25	15.62208	.375117
11	8.76047	.649581	26	15.98277	.360689
12	9.38507	.624597	27	16.32958	.346816
13	9.98565	.600574	28	16.66306	.333477
14	10.56312	.577475	29	16.98371	.320651
15	11.11839	.555265	30	17.29203	.308319

of his estate, the present worth of the remainder interest at the time of death should be obtained by multiplying the value of the property at the time of death by the figure in column 3 of Table A opposite the number of years nearest to the age of the life tenant. Where the remainder interest is subject to an estate for a term of years Table B should be used.

Example: The decedent was entitled to receive property worth $50,000 upon the death of his elder brother, to whom the income for life had been bequeathed. The brother at the time of the decedent's death was 31 years old. By reference to the table it is found that the figure in column 3 opposite 31 years is 0.31262. The present worth of the remainder interest is, therefore, $15,631.

(Reg. 63, Art. 15.)

Where annual income is not determinable, the basis of 4 per cent to be used in calculating the annuity is too low. Resort to it should not be made until every other evidence as to possible income from the source in question has been reviewed. For the last two years any "gilt edge" interest-bearing investment has yielded considerably more than 4 per cent. Unless proof can be established to the contrary, the benefit is distinctly to the government and not to the taxpayer. For instance, the present worth of an annuity of $1 for twenty years at 4 per cent (Table B-2) is $13.59, whereas the same

annuity at 8 per cent would show a present worth of $9.818. Granted that a straight annuity, providing as it does for the average rate of interest covering a period of years, can be estimated on a 4 per cent basis, nevertheless, in the hypothetical instance illustrated in the regulation, where $100,000 was at the disposal of the trustees for investment, it might well be that at the time of the decedent's death this sum could be invested in bonds yielding 5½ per cent to 6 per cent. The value under such circumstances should be based on actual market conditions rather than on hypothetical rates which would not represent the actual value at the date of decedent's death, which is the value called for in the law. It is of interest to note that the first tables showing present worth of life interests in personal property based on the same rate as those now in existence, 4 per cent, were promulgated by the Commissioner of Internal Revenue as long ago as December 16, 1898, (Spanish War Revenue Act, 1898). The Supreme Court of the United States expressed the opinion that "at the time this tax was collected (1899) 4 per cent was very generally assumed to be the fair value or earning power of money safely invested."[15]

Dower and Curtesy.—

LAW. Section 402. **That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated— . . . .**

(b) To the extent of any interest therein of the surviving spouse, existing at the time of the decedent's death as dower, curtesy, or by virtue of a statute creating an estate in lieu of dower or curtesy. . . . .

REGULATION. This provision includes dower and curtesy and all interests created by statute in lieu thereof, although the estate or interest so created is different in character. The effect of the provision is to require the inclusion of the full value of the property, without deduction of the value of the interest of the surviving husband or wife. This rule does not apply to the estate of any decedent

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[15] *Simpson v. United States,* 252 U. S. 547, 40 Sup. Ct. 367, 64 L. Ed. 709.

dying after September 8, 1916, and prior to 6.55 p.m. February 24, 1919 (the effective date of Title IV of the Revenue Act of 1918), unless the property has its situs in a jurisdiction wherein dower, curtesy, or the statutory interest in lieu thereof is subject to the payment of charges against the estate, the expenses of its administration, and is subject to distribution as part of the estate, or unless there has been an election to take property devised or bequeathed in lieu of dower, curtesy, or such statutory interest, and the property so taken has its situs in a jurisdiction by the laws of which it is subject to the payment of such charges and expenses, and to distribution as a part of the estate. (Reg. 63, Art. 16.)

Transfers by decedent in his lifetime.—Under ordinary circumstances it is somewhat difficult to substantiate the fact that a transfer of property, either by means of a trust or otherwise, made without consideration and within two years of death, was not executed in contemplation of death. This difficulty is not lessened by the burden of proof resting on the executor to show the contrary.

Law. Section 402. **That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, whereever situated— . . . .**

(c) To the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has at any time created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death (whether such transfer or trust is made or created before or after the passage of this Act), except in case of a bona fide sale for a fair consideration in money or money's worth. Any transfer of a material part of his property in the nature of a final disposition or distribution thereof, made by the decedent within two years prior to his death without such a consideration, shall, unless shown to the contrary, be deemed to have been made in contemplation of death within the meaning of this title; . . . .

Regulations. A transfer made by the decedent at any time, and in any manner, is taxable when made in contemplation of or intended to take effect in possession or enjoyment at or after his death, provided it was not a *bona fide* sale for a fair consideration in money or money's worth. To constitute such a sale it must have been made in good faith, and the price must have been a fair equivalent, and reducible to a money value. The value of property, where title was so transferred by the decedent before September 9, 1916,

is to be included in his gross estate if his death occurred after the effective date of the Revenue Act of 1918, but is not to be included if he died prior thereto. (Reg. 63, Art. 17.)

The words "in contemplation of death" do not mean, on the one hand, a general expectation of death such as all persons entertain, nor, on the other, is the meaning limited to an expectation of immediate death. A transfer, however, is made in contemplation of death wherever the person making it is influenced to do so by such an expectation of death, arising from bodily or mental conditions, as prompts persons to dispose of their property to those whom they deem proper objects of their bounty. Such a transfer is taxable, although the decedent parts absolutely and immediately with his title to and possession and enjoyment of the property. Any transfer made by a decedent within two years prior to his death, without a fair consideration in money or money's worth, is presumed to be taxable if of a material part of his property and in the nature of a final disposition or distribution thereof. The executor must return the value, as of the date of decedent's death, of all property transferred by the decedent at any time in contemplation of death, where the transfer was not a bona fide sale for a fair consideration in money or money's worth, and must disclose in the return all transfers of a material part of decedent's property made at any time without such consideration, but need not include in the gross estate the value of such thereof as he contends were not made in contemplation of death, in which event he may submit with the return evidence of all material facts tending to disclose the decedent's motive at the time, his then anticipation of death, and mental and physical condition.

The presumption of taxability of a transfer made within the two-year period may be rebutted by proof that it was not made under the conditions stated in the statute, and such proof must be filed with the return. Unless proof is submitted which is sufficient to rebut the presumption the transfer will be included in the gross estate in computing the tax.

The fact that a gift was made as an advancement, to be taken into account upon the final distribution of the decedent's estate, is not enough, standing alone, to establish taxability. (Reg. 63, Art. 18.)

All transfers at any time made by the decedent, other than bona fide sales for a fair consideration in money or money's worth, which were intended to take effect in possession or enjoyment at or after his death, are taxable, and the value of the property so transferred, as of the date of the decedent's death, must be returned as a part of the gross estate. (Reg. 63, Art. 19.)

A transfer, not amounting to a bona fide sale for a fair consideration in money or money's worth, is taxable where the decedent reserved to himself during life the income of the property transferred.

In such a case the transfer of the principal takes effect in possession and enjoyment at the death of the decedent, and the value of the entire property should be included in the gross estate. Where the decedent reserved a proportionate part of the income, only a corresponding proportion of the value of the property should be included in the gross estate. If, for example, he reserved one-half of the income, the value of one-half of the property transferred should be included in the gross estate. If he reserved an annuity, so much of the property as is necessary to produce the annuity should be included in the gross estate. A transfer is taxable in accordance with these principles whether the decedent reserved the annuity out of the property conveyed, or payment thereof to him was made by the grantee upon an express or an implied agreement to that effect. Where, however, the transfer was made in contemplation of death, the full value of the transferred property, as of the date of the decedent's death, should be included in the gross estate irrespective of the amount of income or of the annuity payable to the decedent.

A gift of the principal intended to take effect either in possession or enjoyment at or after the decedent's death is taxable, although the income during the decedent's life was payable to some one other than himself. Example: The decedent transferred property to his son, the latter agreeing to pay the income to his mother during the decedent's life. The transfer to the son is taxable. (Reg. 63, Art. 20.)

The expression, "in contemplation of death," was held in the United States Circuit Court of Appeals[16] for the Sixth Circuit not to mean

. . . . on the one hand the general expectancy of death which is entertained by all persons. . . . . On the other hand, the meaning of the term is not necessarily limited to an expectancy of immediate death or a dying condition. . . . . Nor is it necessary, in order to constitute a transfer in contemplation of death, that the conveyance or transfer be made while death is imminent, while it is immediately impending by reason of bodily condition, ill health, disease, or injury or something of that kind. But a transfer may be said to be made in contemplation of death if the expectation or anticipation of death in either the immediate or reasonably distant future is the moving cause of the transfer.

Generally speaking, the only argument in support of the contention that transfers within two years were not in contemplation of death, that can be urged with a measurable

[16] *Shwab v. Doyle,* 269 Fed. 321; reversed — U. S. —, 66 L. Ed. —, 42 Sup. Ct. 391.

promise of success, arises where a sequence of events shows that the decedent, having had an eminently satisfactory business career, decides gradually to relinquish an active control of his interest and to enjoy the remainder of his life in well-earned ease. In such a case, the decedent is not contemplating death but rather a new lease of enjoyable life. The material factor then is the ultimate cause of death. Should it be that the state of decedent's health at the time the transfer was effected showed symptoms of the disease or ailment which was the ultimate cause of death, there is very little likelihood that any proof, however strong in circumstantial evidence, would enable the executor to prove that the property transferred was not in contemplation of death within the meaning of the law. The last hope would center in affidavits from reputable doctors to the effect that although such symptoms must have existed, decedent might have been quite ignorant of their fatal significance—could such conceivably be the case.

The ultimate disposition of a transfer effected less than two years before death depends entirely upon the available evidence and arguments showing the intention of the decedent. It is important that all of the evidence be assembled in the brief, which should be filed in support of the claim.

A widow, one year before her death, conveyed by means of an absolute transfer a considerable amount of property. She died of apoplexy resulting primarily from hardening of the arteries. It was held by the United States Circuit Court of Appeals,[17] that the conveyance was made in contemplation of death. On appeal to the United States Supreme Court[18] this decision was reversed, it being held that a trust created prior to the passage of the Revenue Act but intended to take effect after the death of the creator of the trust, who died after the passage of the act, is not taxable as a transfer in contemplation of death.

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[17] *Shwab v. Doyle,* 269 Fed. 321; reversed — U. S. —, 66 L. Ed. —, 42 Sup. Ct. 391.

[18] — U. S. —, 66 L. Ed. —, 42 Sup. Ct. 391.

This principle has been enunciated in the cases of *Shwab v. Doyle*,[19] *Union Trust Co. v. Wardell*,[20] and *Levy v. Wardell*,[21] all decided May 1, 1922.

RULING. Act of September 8, 1916, Title II, is prospective and not retroactive in operation, and section 202(b) thereof is therefore not applicable to a trust created prior to the passage of the Act, but intended to take effect in possession or enjoyment at or after the death of the creator of the trust who died subsequently to the passage of such Act. . . . . (I-27-394; T. D. 3338.)

The Treasury Department in a circular dated August 7, 1922, has announced that, despite its previous statement to the contrary, it will be necessary for all taxpayers who are entitled to a refund of estate taxes by reason of the decision of *Union Trust Co. v. Wardell, Collector,* and *Shwab v. Doyle, Collector,* to make formal claims therefor on form 843, which claims must be filed within four years next after the payment of such taxes.

REVOCABLE TRUSTS.—

REGULATION. Property held in trust under any instrument in which the decedent reserved a power of revocation, or any power which has that effect, constitutes a part of the gross estate. For example, where a decedent placed property in trust for the present benefit of his son, but reserved the power to revoke the trust at any time during his life, the value of the entire property transferred should be included in the gross estate. (Reg. 63, Art. 21.)

It has been contended in cases arising under the inheritance laws of various states, that revocable trusts are not taxable merely because the trust agreement reserved a power of revocation which the grantor in his lifetime failed to exercise.

In the case of *Bullen v. Wisconsin*,[22] Bullen conveyed certain property in trust, retaining the income for life and reserving the power to repossess all the property at any time prior to death. It was held that the conveyance was not such

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[19] *Ibid.*
[20] — U. S. —, 66 L. Ed. —, 42 Sup. Ct. 393.
[21] — U. S. —, 66 L. Ed. —, 42 Sup. Ct. 395.
[22] 240 U. S. 625, 60 L. Ed. 830, 36 Sup. Ct. 473.

a transfer of property as to exempt it from the inheritance tax of the State of Wisconsin.

The courts of the State of New York, however, have held that the reservation of a power of revocation does not render the transfer taxable. (*Re Wing,* 190 N. Y. S. 908; *Re Bowers,* 195 App. Div. 548, 186 N. Y. S. 912, affirmed 231 N. Y. 613; *Re Flynn,* 190 N. Y. S. 905.)

Valuation of property transferred.—The rules of valuation already dealt with apply to property included under the caption of transfers. The value at the time of decedent's death includes only the original property transferred; any additions or betterments effected by the transferee, or portions of trust not originally contributed or owned by the decedent are excluded from inclusion in the gross estate.

Regulation. The property to be valued is the interest owned and transferred by the decedent; but the value of such property must be ascertained as of the date of the decedent's death. Where the transferee makes additions to the property, or betterments, the enhanced value of the property at that date, due to such additions or betterments, is not to be included. (Reg. 63, Art. 22.)

Property held jointly.—The following section of the 1921 law is considerably enlarged as compared with the same section in the 1918 law. In the latter any property which at any time had been in the possession of the decedent was to be included in the gross estate.. The new provision by allowing for the inclusion of what may have been acquired from the decedent for a fair consideration, or in any case up to the amount of such consideration, removes an obvious hardship to the taxpayer which resulted under the arbitrary provision of the 1918 law. Gifts or bequests common to both spouses, also included now for the first time in this section, are placed on an equitable basis by law.

Law. Section 402. That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated— . . . .

(d) To the extent of the interest therein held jointly or as tenants in the entirety by the decedent and any other person, or deposited in banks or other institutions in their joint names and payable to either or the survivor, except such part thereof as may be shown to have originally belonged to such other person and never to have been received or acquired by the latter from the decedent for less than a fair consideration in money or money's worth: *Provided,* That where such property or any part thereof, or part of the consideration with which such property was acquired, is shown to have been at any time acquired by such other person from the decedent for less than a fair consideration in money or money's worth, there shall be excepted only such part of the value of such property as is proportionate to the consideration furnished by such other person: *Provided further,* That where any property has been acquired by gift, bequest, devise, or inheritance, as a tenancy in the entirety by the decedent and spouse, or where so acquired by the decedent and any other person as joint tenants and their interests are not otherwise specified or fixed by law, then to the extent of one-half of the value thereof; . . . .[23]

REGULATIONS. The statute provides for the inclusion in the gross estate of interests held jointly by the decedent and any other person or persons, and of estates by the entirety. This class of property includes all interests, whether in real or personal property, where the survivor takes the entire property by right of survivorship, and consequently the decedent's interest therein forms no part of his estate for purposes of administration. It does not include interests held as tenants in common, where the interest of each tenant passes free from any right of survivorship.

The following are examples of this class: Real estate held by joint tenants; real estate held by husband and wife (known as an estate by the entirety); money deposited in a bank or trust company in the joint names of the decedent and another and payable to either or the survivor; and, in general, all securities and other personal property, where the title thereto was vested in the decedent and one or more other persons, subject to the right or survivorship. (Reg. 63, Art. 23.)

The entire value of such property is prima facie a part of the decedent's gross estate, but as it is not the intent of the statute that there should be so included a greater part or proportion thereof than is represented by an outlay of funds, which, in the first instance, were decedent's own, or more than a fractional part equal to that of the other joint owner where neither had parted with any considera-

[23] **[Former Procedure)** 1918 LAW. Section 402. . . . . (d) To the extent of the interest therein held jointly or as tenants in the entirety by the decedent and any other person, or deposited in banks or other institutions in their joint names and payable to either or the survivor, except such part thereof as may be shown to have originally belonged to such other person and never to have belonged to the decedent; . . . .

tion in its acquirement, facts, which in a given case bring it within any one of the exceptions enumerated in the statute, may be submitted by the executor.

Whether the value of the entire property, or only a part, or none of it, enters into the make-up of the gross estate, depends upon the following considerations: (1) So much of the property (whether the whole, or a part thereof) as originally belonged to the other joint owner, and which at no time in the past had been received or acquired by the latter from the decedent for less than a fair consideration in money or money's worth, forms no part of the decedent's gross estate. (2) Where the facts are otherwise the same as in (1), but the decedent paid to such other joint owner a consideration for the interest by him (the decedent) acquired in the property, then such portion of the value of the property, proportionate to the consideration so paid, constitutes a part of the gross estate. (3) Where the property, or a part thereof, or a part of the consideration wherewith it was acquired, had at any time been acquired by the other joint owner from the decedent as a gift, or for less than a fair consideration in money or money's worth, then such portion of the value of the entire property, proportionate to the consideration, if any, which in the first instance was paid from such other joint owner's own funds, forms no part of the gross estate. (4) Where the property was acquired by the decedent and his or her surviving spouse as tenants in the entirety by gift, will, or inheritance, then but one-half of the value of the property becomes a part of the gross estate. (5) Where acquired by the decedent and the other joint owner as joint tenants by gift, will, or inheritance, and their interests are not otherwise specified, or fixed by law, then one-half only of the value of the property is a part of the gross estate; or, where so acquired by the decedent and two or more persons, and the interests of the several joint tenants are not otherwise determinable, then the decedent and the other joint tenants surviving him shall each be deemed the owner of an equal fractional part, and the value of one only of such fractional parts is to be included in the gross estate.

The following are given as illustrative: (*a*) The decedent may have furnished the entire purchase price, in which case the value of the entire property should be included in his gross estate; (*b*) the decedent may have furnished a part only of the purchase price, in which case only the value of a corresponding portion of the property should be so included; (*c*) the decedent, prior to acquisition of the property by himself and the other joint owner, may have given to the latter a sum of money which later constituted such other joint owner's entire contribution to the purchase price of the property, in which case the entire value of the property should be included; (*d*) the other joint owner, at a date prior to the acquirement of the

property, may have acquired from the decedent, for less than a fair consideration in money or money's worth, property which thereafter became as such, or in a converted form, part of the purchase price of the property. In such a case, the value of the property to be included is to be reduced proportionately to the consideration furnished by the other joint owner in the original transaction; (*e*) the decedent may have furnished no part of the purchase price, in which case no part of the property should be included; (*f*) the decedent and spouse may have acquired the property by will as tenants by the entirety, in which case one-half of the value of the property should be included. (Reg. 63, Art. 24.)

The regulations which governed the corresponding section of the 1918 law[24] interpreted that section in accord with what is now included in the law itself.

The expression "originally belonged" has been interpreted (T. D. 3225) as referring, not to the time of death, but to the time a joint interest was created. The act does not become retroactive because it measures a transfer tax on property which decedent has given away in his lifetime. In other words, the passing of property has, generally speaking, to be taxed under the estate tax law sooner or later, and the establishment of trusts or joint interests does not automatically release property of the decedent therein included from the application of the law.

In the case of joint tenancies and tenancies by the entirety, it has been held by the United States Supreme Court in the case of *Knox v. McElligott*,[25] decided May 1, 1922, that the provisions for the taxation of joint estates under the Act of 1916, as amended by the Act of 1917, were not retroactive. In other words, then, where a joint estate or estate by the entirety was created prior to the passage of that act, it was not subject to tax on the death of one joint-tenant.

[24] Reg. 37, 1918, Arts. 28 and 29.

[25] — U. S. —, 42 Sup. Ct. —, 66 L. Ed. —. In this case the Circuit Court of Appeals (275 Fed. 545) held that the surviving tenant's original half-interest in a joint-tenancy created prior to the enactment of the statute, formed part of the decedent's gross estate. This decision was reversed upon appeal.

COMMUNITY PROPERTY.—In applying the tax levied under this title, consideration must be given to decisions of state courts construing local statutes. Particularly is this true in connection with community property.[26] A test case, in so far as the California statutes are concerned, was brought in the United States District Court, Northern District, California.[27] The question before the court was as to there being a transfer of any estate, under the California law, when one-half of the community property became vested in the widow upon death of the husband. The court, in overruling a demurrer, in effect held that a wife, under community property laws, no longer takes her interest in the community property as heir, and hence that her interest is not subject to the federal inheritance tax imposed on the transfer of a decedent's estate. The court said:

> The community property act of 1917 is valid as to community property acquired before its passage (*Arnett v. Reade*, 220 U. S. 311, 320, 31 Sup. Ct. 425, 426, 55 L. Ed. 477, 36 L. R. A. (N. S.) 1040), and if that act does not recognize in the wife a valid subsisting, vested interest and estate in the community property during the life of the husband, language is without meaning and legislation without avail. When the husband had the management and control of the community property, with the like absolute power of disposition as of his own separate estate, a decision that the wife had a mere expectancy was plausible, if unsound. . . . . In all the community property states, from the necessity of the case, the agency of the husband as head of the family is much broader, and his control and dominion over personal property much greater, than in the case of real property; but it has never been supposed that this difference lessens the estate of the wife in community personal property, or calls for a different rule of succession.[28]

In so far as the life usufruct[29] in favor of a widow under the Louisiana Civil Code is concerned, it has been decided

[26] For a discussion of community property in relation to the Revenue Act of 1921, see page 408 *et seq.*

[27] *Blum v. Wardell*, 270 Fed. 309.

[28] This case was affirmed on appeal, 276 Fed. 226. Petition for writ of certiorari was denied March 6, 1922, — U. S. —, 66 L. Ed. —, 42 Sup. Ct. 271.

[29] "The right of enjoying things belonging to another and of drawing from them all the profit and advantage they will produce without destroying or wasting their substance." (Funk and Wagnall's *New Standard Dictionary.*)

that such value is not deductible from the gross estate in computing the federal estate tax.[30]

The matter of community property is dealt with generally and conclusively in the following:

Ruling. In Washington, Arizona, Idaho, New Mexico, Louisiana and Nevada there should be included in gross estate, in computing the estate tax of a deceased spouse, one-half only of the community property of husband and wife domiciled therein; this is not based upon any statute enacted subsequent to March 1, 1913 and applies under estate tax acts prior to the Revenue Act of 1918.[31]

Texas is included in the same category as the states enumerated above.[32]

Property passing under power of appointment.—The intention of the law is to reach all the property which a decedent had enjoyed during his lifetime. This includes not only such as he owned but also property of which he had merely the right to direct the disposition by his will or by a deed.

Law. Section 402. That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated— . . . .

(e) To the extent of any property passing under a general power of appointment exercised by the decedent (1) by will, or (2) by deed executed in contemplation of, or intended to take effect in possession or enjoyment at or after, his death, except in case of a bona fide sale for a fair consideration in money or money's worth; . . . .

The provision made in this section is the same as in the 1918 law, and was included in that law in order specifically to embrace property transferred by a power of appointment. Section 202 (c) of the Revenue Act of 1916 served as a general provision which was intended to include such property in its provisions. This intent was more or less obscure. The 1916 law relied upon the rule generally followed, that equity will regard the property appointed under a power of appoint-

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[30] T. D. 3222.
[31] T. D. 3138.
[32] T. D. 3071.

ment, either by deed or will, as part of the assets of the appointor. Nevertheless, it was held that, "The Revenue Act of 1916 did not impose an estate tax upon property passing under a testamentary execution of a general power of appointment."[33]

By "a general power of appointment" is meant the power which is often given by a will to the life beneficiary of a trust fund to name or appoint the persons who shall receive the principal after his life estate shall have terminated. Such principal, under the estate tax law, is taxable as the property of the life beneficiary at his death if he exercises the power of appointment by his will or by a deed made in contemplation of death or intended to take effect at or after his death (except in the case of a bona fide sale for a fair consideration). The principal is therefore to be included in the appointor's gross estate.

Regulations. The value of all property passing under a general power of appointment must be included in the gross estate of the person exercising the power (known as the donee, or appointor) where the power is exercised by will. It should also be so included when the power is exercised by deed or other instrument executed in contemplation of, or intended to take effect in possession or enjoyment at or after, the death of the donee of the power. The statute, however, does not require inclusion within the gross estate of the value of the appointed property in the case of a bona fide sale thereof by the donee of the power for a fair consideration in money or money's worth.

Only property passing under a *general* power should be included. A general power is one to appoint to any person or persons in the discretion of the donee of the power. Where the donee is required to appoint to a specified person or class of persons, the property should not be included in his gross estate. Property appointed under a general power should be so included, although the persons to whom the appointment was made would have taken the property had the power not been exercised. A copy of the instrument granting the power should be filed with Form 706[34] in all cases in order that the Commissioner may determine whether the power is general or special.

Example: The income of property is left to a person for life, with the right to name in his will the person who shall receive the property upon his death. He exercises this power in his will. Upon his

[33] *U. S. v. Field*, 255 U. S. 257, 65 L. Ed. 617, 41 Sup. Ct. 256.
[34] Form 706 is the estate tax return form.

death, the value of the property so appointed should be included in his gross estate. (Reg. 63, Art. 25.)

The provisions of the Revenue Act of 1918, and those of the present statute, respecting transfers effected through the exercise of a general power of appointment are identical, hence, subject to the exception stated in the preceding article, namely, where the appointment was made for a fair consideration in money or money's worth, the value of all property so transferred by the decedent in the exercise of such a power must be included in the gross estate, if his death occurred subsequent to 6.55 p. m., February 24, 1919 (the effective date of the Revenue Act of 1918). Where, however, the decedent died prior to the effective date of the Revenue Act of 1918, the value of the appointed property is not to be so included. (Reg. 63, Art. 26.)

The right to tax property passing under a general power of appointment does not solely depend on whether or not the property is subject to the claims of the creditors of the appointor. Such property to be subject to the estate tax involved must also be property subject to distribution as a part of the decedent's estate. "It is the general rule of the common law, subject to certain exceptions, that the appointee of an estate takes from the original donor and not from the donee of the power."[35]

Insurance.—It is recognized that a reasonable amount of life insurance should pass to beneficiaries free from tax. The amount exempted in the 1921 law is $40,000, just as under the 1918 law.

Law. Section 402. **That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated— . . . .**

(f) To the extent of the amount receivable by the executor as insurance under policies taken out by the decedent upon his own life; and to the extent of the excess over $40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life.

Regulations. The statute provides for the inclusion in the gross estate of certain forms of insurance taken out by the decedent

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[35] *Ebersole v. McGrath*, 271 Fed. 995. An appeal in this case was dismissed, 272 Fed. 1022.

upon his own life. Two kinds of insurance are taxable: (*a*) all insurance receivable by, or for the benefit of the estate; (*b*) all other insurance to the extent that it exceeds in the aggregate $40,000. The term "insurance" refers to life insurance of every description, including death benefits paid by fraternal beneficial societies, operating under the lodge system. Insurance is deemed to be taken out by the decedent in all cases where he pays the premiums, either directly or indirectly, whether or not he makes the application. On the other hand, the insurance is not deemed to be taken out by the decedent, even though the application is made by him, where the premiums are actually paid by the beneficiary, who may be either a person or a corporation. Where the decedent takes out insurance in favor of another person or corporation, as collateral security for a loan or other accommodation, and either directly or indirectly, pays the premiums thereon, the insurance must be considered in determining whether there is an excess over $40,000. The amount of the loan outstanding at decedent's death with interest accrued thereon to that date, will be deductible in determining the net estate. (See Art. 39.) Where the decedent assigns a policy, and retains no interest therein, and thereafter pays no part of the premiums, the insurance will not be considered in determining whether there is such an excess. (Reg. 63, Art. 27.)

The provision requiring the inclusion in the gross estate of all insurance receivable by the executor, without any deduction, applies to policies made payable to the decedent's estate or his executor or administrator, and all insurance which is in fact receivable by, or for the benefit of, the estate. It includes insurance taken out to provide funds to meet the estate tax, and any other taxes or charges which are enforceable against the estate. The manner in which the policy is drawn is immaterial so long as there is an obligation, legally binding upon the beneficiary, to use the proceeds in payment of such taxes or charges. (Reg. 63, Art. 28.)

The estate is entitled to only one exemption of $40,000 upon insurance receivable by beneficiaries other than the estate. For example, if the decedent left life insurance payable to three such beneficiaries in amounts of $10,000, $40,000, and $50,000 (total, $100,000), the amount of $60,000 should be returned for taxation, which is the excess of the sum of the three policies over the exempted amount. The word "beneficiaries," as used in reference to the $40,000 exemption, means persons entitled to the actual enjoyment of the insurance money. (Reg. 63, Art. 29.)

Insurance receivable by the estate must be included in the gross estate of all decedents who died after September 8, 1916. Insurance payable to beneficiaries other than the estate, however, need not be included in the gross estate of decedents who died before the effective

date of Title IV of the Revenue Act of 1918, unless the insurance was originally payable to the estate, and the policy was thereafter assigned, or made payable, to a specific beneficiary in contemplation of, or intended to take effect in possession or enjoyment at or after the decedent's death; such assignment or change in beneficiary not being for a fair consideration in money or money's worth. (Reg. 63, Art. 30.)

The amount to be returned in the case of any policy is the amount receivable by the estate or other beneficiary. In cases where the proceeds of a policy are made payable to the beneficiary in the form of an annuity for life or for a term of years, the present worth of the annuity at the time of death should be included in the gross estate. For the method of computing the value of such an annuity, see Article 15.[36] Where the insurance contract gives an option to receive a fixed sum of money in lieu of an annuity, this sum, if accepted, represents the value of the insurance for the purpose of the tax. If such sum is not accepted the value of the annuity is to be included in the gross estate. Where there is more than one option, and none of them is convertible, the value of the insurance should be determined in accordance with the option actually exercised. (Reg. 63, Art. 31.)

When premiums are paid by other persons and the executor is not required to include the proceeds of the insurance in the gross estate of the decedent, care must be exercised to see that such payments were not constructive payments by the deceased; as, for instance, where premiums are paid by a corporation on behalf of an official as part of the latter's compensation for services, the benefit of such insurance accruing to the official's heirs or assigns. This benefit would form part of the gross estate in so far as it, or any portion of it, was in excess of $40,000. All insurance coming under the provisions of this section must be included in detail in schedule C of form 706. The amounts of insurance payable to beneficiaries, other than the executor, not in excess of $40,000, are not extended. The balance, if any, is extended and so comprised in the total gross estate reported in this schedule. The inclusion of insurance effected as security for indebtedness is obviously correct, the indebtedness itself being an offset for inclusion in deductions from gross estate in schedule I.

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[36] See page 1393 *et seq.*

The constitutionality of taxing the proceeds from life insurance policies payable to beneficiaries other than the estates of decedents is open to question. The estate tax is "imposed upon the transfer of the net estate of every decedent."[37] The estate of the decedent consists of all property of which the decedent dies seized and possessed, and which can be devised by him; or, if he dies intestate, is distributed according to the statutes of descent and distribution as provided by law. The property is of such a nature as to be liable for his debts. The proceeds of life insurance which do not go to a decedent's estate never formed any part of the decedent's estate, nor were they liable for his debts. Where endorsed to a third party, no reversionary interest or equity entered into the value of the decedent's estate prior to his death.

In this connection the following dissenting opinion of Mr. Justice Holmes is pertinent:

> Decision. . . . . If the succession has fully vested, or has passed beyond dependence upon the continuing of the state's permission or grant, an attempt to levy a tax under the power to regulate succession would be an attempt to appropriate property in a way which the 14th Amendment has been construed to forbid.[38]

A test as to the taxability of this form of insurance is furnished in a case before the United States District Court of Maryland.[39] The testator, two months before his death, had caused three insurance policies to be made payable to his son and daughter. He reserved no interest to himself nor to his personal representatives. The transfers were made without consideration and within two years of his death. The court decided:

> Decision. Under all the circumstances, I do not feel justified in holding that the three policies, which were absolutely assigned, were within the statutory meaning of the phrase "transferred in contemplation of death."

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[37] Section 401.
[38] *Chanler v. Kelsey,* 205 U. S. 466, 479, 51 L. Ed. 882, 27 Sup. Ct. 550.
[39] *Gaither v. Miles,* 268 Fed. 692.

These three policies, therefore, did not remain a part of the decedent's estate, so as to be subject to the estate tax.

The above decision is conclusive in its expression. If, even within two months of death, these insurance policies were not considered as "made in contemplation of death" within the meaning of the statute, it would seem that any absolute transfer effected in such a manner could be reasonably held to be without the power of the estate tax law.

Taxpayers will await with interest the decision of a suit brought in the United States District Court in Pittsburgh on October 7, 1922, by the executors of the will of H. C. Frick in which they seek to recover $108,657.38 with interest from May 31, 1921. It is alleged that the sum was erroneously and unlawfully collected by the Collector of Internal Revenue for that district, as a tax on $434,629.52 insurance on the life of Mr. Frick which was payable to beneficiaries other than the executors of the estate. The executors stated that the insurance policies were taken out by Mr. Frick on his own life and made payable to the respective individual beneficiaries and were not part of the estate or property which Mr. Frick left at the time of his death, and were not liable for the payment of his debts or distributable as part of his estate. It is set forth that the beneficiaries have received the proceeds of the policies because of their ownership thereof and not by virtue of any succession inheritance or transfer laws of Pennsylvania. It is claimed that under the Revenue Act of 1918 the collection of such a tax is taking property without due process of law, in violation of the Fifth Amendment to the Constitution of the United States.

The issue is thus squarely presented on a basis which should result in a final authoritative decision, and it is to be hoped that the inevitable delays of judicial procedure will not unduly prolong the uncertainty which now exists on this point.

Deductions from Gross Estate

Deductions allowed resident estates.—Having computed the amount of the gross estate, the next step is to ascertain the allowable deductions.

LAW. Section 403. That for the purpose of the tax the value of the net estate shall be determined—

(a) In the case of a resident, by deducting from the value of the gross estate—

(1) Such amounts for funeral expenses, administration expenses, claims against the estate, unpaid mortgages upon, or any indebtedness in respect to, property (except, in the case of a resident decedent, where such property is not situated in the United States), losses incurred during the settlement of the estate arising from fires, storms, shipwreck, or other casualty, or from theft, when such losses are not compensated for by insurance or otherwise, and such amounts reasonably required and actually expended for the support during the settlement of the estate of those dependent upon the decedent, as are allowed by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered, but not including any income taxes upon income received after the death of the decedent, or any estate, succession, legacy, or inheritance taxes; . . . .

DEDUCTION OF CLAIMS, EXPENSES, ETC.—

REGULATION. In order to be deductible under the foregoing provision of the statute, the item must fall within one of the several classes of deductions specifically enumerated therein, and must also, except in the case of deductible losses during the administration of the estate, be one the payment of which out of the estate is authorized by the laws of the jurisdiction under which the estate is being administered. Unless both of these conditions exist, the item is not deductible. Where the item is not one of those described, it is not deductible merely because payment is allowed by the local law. Where the amount which may be expended for the particular purpose is limited by the local law, no deduction in excess of such limitation is permissible. An item may be entered on the return for deduction though the exact amount thereof is not then known, provided it is ascertainable with reasonable certainty, and will be paid. No deduction may be taken upon the basis of a vague or uncertain estimate. When an uncertain or contingent liability was undetermined at the time of audit of the return by the Commissioner, and, as a consequence, deduction was not allowed therefor in such audit, the remedy is by a claim for abatement or refund when the liability and the amount thereof becomes fixed and determined. (See Arts. 93 to 97, inclusive.) (Reg. 63, Art. 32.)

Funeral expenses.—

Regulation. An executor may deduct such amounts for funeral expenses as are actually expended by him, provided expenditures of this nature are a liability of the estate under the laws of the local jurisdiction. A reasonable expenditure by the executor for a tombstone, monument, or mausoleum, or for a burial lot, either for the decedent or his family, may be deducted under this heading, provided such an expenditure is made a charge upon the estate by the local law. Included in funeral expenses is the cost of transportation of the person bringing the body to the place of burial. (Reg. 63, Art. 34.)

Administration expenses.—

Regulation. The amounts deductible from the gross estate as "administration expenses" are such expenses as are actually and necessarily incurred in the administration of the estate; that is, in the collection of assets, payment of debts, and distribution among the persons entitled. The expenses contemplated in the law are such only as attend the settlement of an estate by the legal representative preliminary to the transfer of the property to individual beneficiaries or to a trustee, whether such trustee is the executor or some other person. Expenditures not essential to the proper settlement of the estate, but incurred for the individual benefit of the heirs, legatees, or devisees, may not be taken as deductions. Administration expenses include (1) executor's commissions; (2) attorney's fees; (3) miscellaneous expenses. Each of these classes is considered separately. (See Arts. 36 to 38.) (Reg. 63, Art. 35.)

Executor's commissions.—

Regulation. The amount deductible as executor's or administrator's commissions is such amount as has actually been paid or which at the time the return is filed it is reasonably expected will be paid, but no deduction will be allowed if no commissions are to be collected. Where the amount of the commissions has not been fixed by decree of the proper court, the deduction will be allowed on the final audit of the return provided: (1) That the Commissioner is reasonably satisfied that the commissions claimed will be paid; (2) that the amount entered as a deduction is within the amount allowable by the laws of the jurisdiction wherein the estate is being administered; and (3) that it is in accordance with the usually accepted practice in said jurisdiction in estates of similar size and character. Where the commissions claimed have not been awarded by the proper court the Commissioner on final audit may disallow the deduction in part or in whole, as the circumstances in his judgment justify, subject to such future adjustment as the facts may later require. If the deduction is allowed in advance of payment and payment is thereafter

waived, it shall be the duty of the executor to notify the Commissioner. Executors should note that the amounts received in payment of the commissions constitute taxable income and that amounts allowed on final audit are cross-referenced for income-tax purposes.

A bequest to an executor in lieu of commissions[40] is deductible as an administration expense in the amount that it does not exceed commissions allowable under local law and practice.

Amounts paid as trustees' commissions do not constitute expenses of administration and are not deductible, whether received by the executor acting in the capacity of a trustee or by a separate trustee as such. (Reg. 63, Art. 36.)

Attorney's fees.—

Regulation. The amount deductible as attorney's fee is the amount actually paid as such or which at the time the return is filed it is reasonably expected will be paid. If on the final audit of a return, the fees claimed have not been awarded by the proper court and paid, the deduction will be allowed, provided that the Commissioner is reasonably satisfied that the amount claimed will be paid and that it does not exceed a reasonable remuneration for the services rendered, taking into full account the size and character of the estate and local law and practice. Where the attorney's fees have not been paid at the time of the final audit of the return, the Commissioner may disallow the deduction in part or in whole as the circumstances may warrant, subject to such future adjustment as the facts may require.

Attorney's fees incident to litigation instituted by the beneficiaries as to their respective interests do not constitute a proper deduction, inasmuch as expenses of this character are properly charges against the beneficiaries personally and are not administration expenses as contemplated by the statute. (Reg. 63, Art. 37.)

Miscellaneous administration expenses.—

Regulation. This item includes expenses incident to court proceedings, or the administration of the estate, such as court costs, surrogates' fees, accountants' fees, appraisers' fees, clerk hire, etc. Expenses necessarily incurred in distributing the estate are deductible. This includes the cost of storing or maintaining property of the estate, where it is impossible to effect immediate distribution to the beneficiaries. Expenses for preserving and caring for the property may be deducted, but do not include additions or improvements; nor will such expenses be allowed for a longer period than the executor is required to retain the property. A brokerage fee for selling property of the estate is deductible where the sale is necessary in order to

[40] Such a bequest, however, is not taxable income to the executor. *Merriam v. United States*, Circuit Court of Appeals, April 3, 1922.

pay the decedent's debts, or the expenses of administration, or to effect distribution. Other expenses attending the sale are deductible, such as the fees of an auctioneer, where it is reasonably necessary to employ one. (Reg. 63, Art. 38.)

Claims against the estate.—

Regulation. The amounts that may be deducted under this heading are such only as represent personal obligations of the decedent existing at the time of his death, whether then matured or not. Only such claims as are enforceable against the estate may be deducted. (Reg. 63, Art. 39.)

Where the indebtedness of the decedent includes notes payable, care should be taken to ascertain whether such notes are secured by collateral. The value of such collateral would, of course, have to be included in the gross estate.

Taxes.—

Regulation. Taxes upon real property should be accrued to the date of death in order to reflect in the gross estate the value of the property upon which they were imposed. This is done by ascertaining the time between the first day of the taxable period wherein the death occurs and the date of death, and computing the proportion of the entire tax upon the basis which this period bears to the entire taxable period. Such proportion of the tax had accrued upon the date of death, and is deductible.

Taxes upon personal property are either wholly deductible, or are not deductible at all, depending upon whether the tax did, or did not, become the personal obligation of the taxpayer in his lifetime. If the tax became his personal obligation during his life, the whole amount is deductible as a claim against his estate. If it did not become such personal obligation in his lifetime, no part of it is deductible. The question when the tax became the personal obligation of the taxpayer depends upon the law of the jurisdiction imposing the tax. Prima facie, the date when the tax became the personal obligation of the taxpayer is the date when the assessment was laid.

Federal taxes upon income received or accrued during the decedent's lifetime constitute a personal obligation of the decedent, and are deductible. Taxes upon income received after the decedent's death are not deductible. No estate, succession, legacy, or inheritance tax is deductible. (Reg. 63, Art. 40.)

In connection with the deductibility of estate, succession, legacy or inheritance taxes from the gross estate, despite the

fact that estate taxes are included in those not deductible under the law,[41] the government contended, in a court case, that estate taxes were deductible because levied against the estate itself, but that "legacy" taxes were not deductible, because levied aginst the legatee.[42] In this particular case the decision was that the Massachusetts tax should have been deducted before the estate tax was computed. The court also stated it to be "unjust to hold that under this Federal Statute (Revenue Act of 1916) the State tax was deductible in one state and not deductible in another, upon a subtle legalism without practical value." On the other hand, a contrary opinion has been handed down by the Supreme Court of the United States:[43] "'Charges against the estate' as pointed out by the court below, are only charges that affect the estate as a whole, and therefore do not include taxes on the right of individual beneficiaries. This reasoning excludes not only the New York succession tax, but those paid to other states, which can stand no better than that paid in New York." And again, in the United States District Court, Northern District, New York,[44] it was held that the New York transfer tax was a proper deduction to be made in the tax due the United States. As to the Pennsylvania collateral inheritance tax, the court decided[45] that it is an estate tax, not a legacy tax, and that as such it is levied upon and made a charge against the estate. For this reason the court held that the tax was deductible from the gross estate before the imposition of the federal estate tax.

With these conflicting decisions given, it can only be said that the question of deductibility of state estate or inheritance taxes is entirely dependent upon the exact nature of the tax imposed by a particular state.

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[41] Sec. 403 (a-1).

[42] *Thayer et al. v. Malley,* U. S. District Court, Mass., March 28, 1921 (not reported).

[43] *N. Y. Trust Co. et al. v. Eisner,* 256 U. S. 345, 41 Sup. Ct. 506, 65 L. Ed. 963.

[44] *Sayre et al v. Brewster,* 268 Fed. 553.

[45] *Lederer v. Northern Trust Co.,* 262 Fed. 52; certiorari denied, 253 U. S. 487, 64 L. Ed. 1026, 40 Sup. Ct. 483.

Charitable bequests and state transfer taxes.—The following decision of a United States District Court is of interest in cases where a will directs that state transfer taxes shall be charged against the residuary estate, and where the residuary estate is given to charity.

Decision. This is an action brought to recover Federal Estate Taxes imposed by the Revenue Act of 1918. The Commissioner revised the tax reported by deducting from the bequests for charitable purposes, the amount of State transfer taxes, viz., $5,741.83, payable from the residuary estate. He also deducted from the residuary estate going to charity, the Federal Estate Tax. This lessened the amount of the charitable bequests which are made deductible in computing the net estate subject to tax and increased the tax accordingly.

Under Section 403 (a) (3) of the Revenue Act of 1918, there may be deducted "the amount of all bequests, legacies, devises or gifts" to charities. The government in this case wishes to increase the net taxable estate by reducing the deductible residuary bequests to charity which have to pay this $5,741.83 to the extent of that sum. In the case of an estate bequeathed to a single individual, the estate tax might have been computed upon the amount received after the estate had suffered diminution by the tax itself, but such has never been the practice, and the uniform theory has been that the estate passing was to be treated without regard to incidence of the tax itself. A different rule should not be adopted in dealing with the words "the amount of all bequests, legacies, devises or gifts" even when applied to a residue to charity. A subtraction of the amount of all bequests to charity should, therefore, take into account the legacy tax payable out of such bequest by the terms of the will. However, the Federal Estate Tax, although it is a legal charge upon the estate, need not be taken into account, as the uniform practice has been to disregard the Federal Estate Tax in determining the net estate.

It is reasonable to apply the same rule in determining what is the residue which the testatrix gave to charity for the purpose of claiming statutory deduction. See *Dugan v. Miles,* 276 Fed. 401. The judgment is directed for the plaintiffs, with interest, except as to the tax on the sum of $5,741.83, which sum should be deducted from the residue passing to charity and thus added to the net estate for the purposes of taxation.[46]

Unpaid mortgages.—

Regulation. The full amount of unpaid mortgages on property included in the gross estate should be deducted under this heading,

[46] *Slocum et al. v. Edwards,* U. S. Dist. Ct., So. Dist. of N. Y., June 20, 1922. (Not yet reported.)

including interest which had accrued at the time of death, whether payable at that time or not. The full value of the real estate, without any deduction for mortgages, must be returned as part of the gross estate. Real property situated outside the United States is not a part of the gross estate of a resident decedent, nor may deduction be taken of any mortgage upon, or any indebtedness in respect to, such property when owned by a resident decedent. (Reg. 63, Art. 41.)

The exclusion of mortgages on property of a resident decedent which is situated outside the United States is a new provision. Under the 1918 regulations, mortgages on property owned outside the United States were deductible when the decedent was personally liable for the mortgage debt.[47] The latter would seem to be the more equitable treatment.

Losses from casualty or theft.—

Regulation. There may be deducted under this heading losses incurred during the settlement of the estate arising from fires, storms, shipwreck, or other casualty, or from theft, when such losses are not compensated for by insurance or otherwise. If the loss is partly compensated, the excess of the loss over such compensation may be deducted. Losses not of the nature described are not deductible. Losses sustained by reason of depreciation or otherwise in the value of assets of the estate subsequent to the decedent's death, when not arising from any of the causes named, are not deductible. In order to be deductible a loss must occur during the settlement of the estate. Where property has been delivered to the beneficiary, settlement has been effected, and no deduction may be had for loss of the property. (Reg. 63, Art. 42.)

Support of dependents.—

Regulation. The support during the settlement of the estate of dependents of the decedent should be deducted, but pursuant to the following rules:

(1) In order to be deductible, the allowance must be authorized by the laws of the jurisdiction in which the estate is being administered, and not in excess of what is reasonably required.

(2) The allowance for which deduction may be made is limited to support during the settlement of the estate. Any allowance for a more extended period is not deductible.

(3) There must be an actual disbursement from the estate to the dependents, but after payment has been made the right of deduc-

[47] Reg 37, 1918, Art. 47.

tion is not affected by the fact that the dependents do not expend the entire amount for their support during the settlement of the estate. (Reg. 63, Art. 43.)

The governing factor in determining the deductibility of expenses is their allowance as such under local statutes. Careful study of such statutes is therefore necessary, since under some jurisdictions a deduction for the support of dependents is not permitted. Nevertheless, expenses, to be deductible from the gross estate, must come distinctly under some one of the descriptions enumerated in section 403 (a) of the act. Particular attention is drawn to the treatment of the executor's commission where a specific sum has been willed by the decedent for this remuneration. Any such amount in excess of the total commission permitted by the local court is disallowed.

The following regulation explains the consideration which will be given to court decrees in determining the character and amount of claims and expenses.

Effect of court decree on deductibility.—

Regulation. The decision of a local court as to the amount of a claim or administration expense will ordinarily be accepted where the court passes upon the fact upon which deductibility depends. Where the court does not pass upon such fact its decree will, of course, not be followed. For example, where the question before the court is whether a claim should be allowed, the decree allowing it will ordinarily be accepted as establishing that the claim is valid and the amount of it. Where, however, a legacy is left to an executor in lieu of commissions, the allowance of the legacy does not establish that the executor's claim for commissions is equal to the amount bequeathed, and that this amount is consequently deductible. (See Art. 36.) Nor will the decree necessarily be accepted even where it purports to decide the fact upon which deductibility depends. It must appear that the court actually passed upon the merits of the case. This will be presumed in all cases where there is an active and genuine contest. Where the result reached appears to be unreasonable, this is some evidence that there was not such a contest, but it may be rebutted by proof to the contrary. Where the decree was rendered by consent, it will be accepted, provided the consent was a *bona fide* recognition of the validity of the claim—not a mere cloak for a gift—and was accepted by the court as satisfactory evidence upon the merits. It will be presumed that the consent was of this character,

and was so accepted, where it is made by all parties having an interest adverse to the claim, when all aspects of the matter, including its effect upon taxation, are considered. The decree will not be accepted where it appears to be at variance with the law of the state; as, for example, if an allowance is made to an executor in excess of the rate prescribed by statute. (Reg. 63, Art. 33.)

Deduction for property previously taxed.—

LAW. Section 403. That for the purpose of the tax the value of the net estate shall be determined—

(a) In the case of a resident, by deducting from the value of the gross estate— . . . .

(2) An amount equal to the value of any property forming a part of the gross estate situated in the United States of any person who died within five years prior to the death of the decedent where such property can be identified as having been received by the decedent from such prior decedent by gift, bequest, devise, or inheritance, or which can be identified as having been acquired in exchange for property so received: *Provided,* That this deduction shall be allowed only where an estate tax under this or any prior Act of Congress was paid by or on behalf of the estate of such prior decedent, and only in the amount of the value placed by the Commissioner on such property in determining the value of the gross estate of such prior decedent, and only to the extent that the value of such property is included in the decedent's gross estate and not deducted under paragraphs (1) or (3) of subdivision (a) of this section. This deduction shall be made in case of the estates of all decedents who have died since September 8, 1916; . . . .

While in general accord with the corresponding section of the 1918 law,[48] this section also includes some provisions previously covered merely by regulation. The intent is perfectly clear, in that where an estate tax has been paid on the transfer of any portion of the decedent's estate within five years prior to the date of death, no further federal tax need be paid in respect of that particular property.[49]

Only the value accepted by the Commissioner in the return of the prior decedent may be deducted from the gross estate under this section. If the actual value at date of decedent's

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[48] 1918 law, section 403 (a-2); see also Reg. 37, 1918, Art. 50.

[49] As to the effect of the change of the effective date on refunds of tax, see page 1454.

death exceeds the original value the excess must be included in the gross estate.

Property owned by a resident or non-resident decedent which formed part of the estate of anyone dying after September 8, 1916, and upon which an estate tax had been paid, may be deducted from the gross estate. The rules for such deduction may be summarized as follows:

1. The two deaths must have occurred within five years of each other.
2. The first decedent must have died after September 8, 1916, and the second after November 23, 1921, the date when the Revenue Act of 1921 became effective.
3. Tax must have been paid on the first decedent's property.
4. The value exempt from taxation in the case of the last decedent is the value at which such property was included in the gross estate of the prior decedent.
5. The property shall be situated in the United States at the time of the last decedent's death.

The third condition above paves the way for possibility of an injustice in certain cases. It is specifically stated that the filing of a return is not a sufficient cause for deduction[50] but that the tax itself must have been paid. The inevitable construction to be placed on this condition is that the net estate of the first decedent must have exceeded the $50,000 specific exemption; otherwise there would have been no taxable estate and, consequently, no tax paid. Any benefit accruing to the estate of the last decedent, under these circumstances, is entirely dependent on the fact as to whether or not the gross estate of the prior decedent exceeded $50,000.

If the gross estate of the prior decedent exceeded $50,000, then bequests to the second decedent will be deductible from the latter's gross estate. This is true, in spite of the fact that

[50] Reg. 63, Art. 44.

the estate of the prior decedent (if a resident) was only subject to tax on the amount in excess of $50,000.

Where the gross estate of the prior decedent was less than $50,000, no tax was payable (by a resident), and therefore the estate of the second decedent will be unable to deduct any bequests received from the prior decedent.

To illustrate:

(1) Assume A (a resident) had a gross estate of		$100,000
Deduct: Specific exemption		50,000
Tax paid by A's estate on		$ 50,000
B (a resident) has a personal estate excluding payment from A of		$ 40,000
Bequest from A		100,000
Gross estate of B		$140,000
Deduct: A's bequest	$100,000	
Specific exemption	50,000	150,000
Excess of deductions		*$ 10,000*
No tax due on B's estate.		
The Treasury receives in total from the estates of A and B tax on		$ 50,000

(2) Assume A (a resident) had a gross estate of	$ 40,000
No tax is payable by the estate of A.	
B (a resident) has a personal estate excluding bequest from A of	$100,000
Bequest from A	40,000
Gross estate of B	$140,000
Only the specific exemption can be deducted	50,000
Total paid by A's estate on	$ 90,000
The Treasury receives in total from the estates of A and B tax on	$ 90,000

It follows that the discrimination referred to above results in the collection by the Treasury of a tax on $40,000 more in the second case than in the first although the total personal estates (excluding the transfer) of A and B are identical in the two examples, namely, $140,000.

The discrimination is unfair. The Treasury should permit

in the second case the deduction of $40,000 from the estate of B, which is the intention of Congress.

Deduction for property acquired in exchange.—

Regulations. The deduction for substituted property is limited to property acquired in exchange for the identical property received from the prior decedent. Where there is a subsequent exchange, the right to deduction is lost.

In the case of an exchange the executor must describe and identify fully both the property originally received from the prior decedent and the property acquired in exchange therefor. He must also state the date of the transaction by which the exchange was effected and the name and address of the transferee. If the exchange was made by written instrument of public record, a precise reference must be made to the record containing a transcript of the instrument, and, if by instrument not of record, a copy of the instrument itself must be supplied. If there was no written instrument, an affidavit as to the facts of the exchange by one or more persons having personal knowledge of the matter must be furnished. (Reg. 63, Art. 46.)

If the property originally received from the prior decedent is included in the decedent's gross estate, the executor must describe it fully, and prove its identity. (Reg. 63, Art. 45.)

Since the amount of property originally received under the conditions mentioned will have been included (on schedule G of form 706) at its value at the time of decedent's death, the deduction made (on schedule K of form 706) will be at the same figure.

Deduction for charitable and similar bequests.[51]—

Law. Section 403. **That for the purpose of the tax the value of the net estate shall be determined—**

(a) In the case of a resident, by deducting from the value of the gross estate— . . . .

(3) The amount of all bequests, legacies, devises, or transfers, except bona fide sales for a fair consideration in money or money's worth, in contemplation of or intended to take effect in possession or enjoyment at or after the decedent's death, to or for the use of the United States, any State, Territory, any political subdivision thereof,

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[51] [Former Procedure] Provision for the deduction of charitable and similar bequests was first instituted in the 1918 law. That law provided for deductions similar to those which are allowed under the 1921 law. Prior laws made no allusion to this form of deduction from gross estate.

or the District of Columbia, for exclusively public purposes, or to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, or to a trustee or trustees exclusively for such religious, charitable, scientific, literary, or educational purposes. This deduction shall be made in case of the estates of all decedents who have died since December 31, 1917; . . . .

Regulations. In the estates of decedents dying after December 31, 1917, deduction may be taken of the value of all property transferred by will, or by the decedent in his lifetime in contemplation of or intended to take effect in possession or enjoyment at or after his death (not including, however, the value of property sold for a fair consideration in money or money's worth), where, in either case, the property is, or has been, transferred (1) to or for the use of the United States, any State, Territory, any political subdivision thereof, or the District of Columbia, for exclusively public purposes; or (2) to or for the use of any corporation or association organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes (including the encouragement of art and the prevention of cruelty to children or animals), where no part of the net earnings of the corporation or association inures to the benefit of any private stockholder or individual; or (3) to a trustee or trustees exclusively for one or more of the purposes enumerated in (2).

Where a trust is created for both a charitable and a private purpose, deduction may be taken of the value of the beneficial interest in favor of the former only in so far as such interest is presently ascertainable, and hence severable from the interest in favor of the private use. Thus, when money or property is placed in trust to pay the income to an individual during his life, and then to pay or deliver the principal to a charitable corporation, or to apply it to a charitable purpose, the present value of the principal is deductible. For the manner of determining such value, see Article 15.

The deduction is not limited, in the estates of resident decedents, to transfers to domestic corporations or associations, or to trustees for use within the United States. (Reg. 63, Art. 47.)

A corporation or association to which such a transfer was made must meet three tests: (1) it must be organized and operated for one or more of the specified purposes; (2) it must be organized and operated *exclusively* for such purpose or purposes; and (3) no part of its net earnings shall inure to the benefit of private stockholders or individuals.

The estate is not deprived of the right to deduct the value of property so transferred by reason of the fact that private individuals are the recipients of the benefits which the corporation or association dispenses. Such right is, however, lost wherever any part of the net earnings of the corporation or association inures to the benefit of a private stockholder or individual. Thus, if the shareholders or members of the corporation or association are entitled, upon a dissolution thereof, to receive the proceeds of its property, including accumulated net earnings, no right of deduction exists, even though the by-laws provide that the shareholders or members shall not receive dividends or other return upon their shares or interests. (Reg. 63, Art. 48.)

In order to prove the right of the estate to this deduction the executor must submit:

(1) Duplicate copies of the will of the decedent or the instrument, if any, in the case of a transfer of property in contemplation of or intended to take effect in possession or enjoyment at or after death, as required by article 69. Where copies of the will are submitted it will be sufficient if one of these copies is certified, but in such cases the collector should forward the certified copy to the commissioner.

(2) An affidavit by the executor stating whether any action has been instituted to contest the will and whether, according to his information and belief, any such action is contemplated.

(3) Such other documents or evidence as may be requested by the commissioner on review. A return will not be considered as complete within the meaning of section 407 of the act until all such evidence has been submitted. (Reg. 63, Art. 49.)

Where the transfer is dependent upon the performance of some act or the happening of some event in order to become effective, it is necessary that the performance of the act or the occurrence of the event shall have taken place before the deduction can be allowed.

Where the legatee, devisee, donee, or trustee is empowered to divert the property or fund, in whole or in part, to a use or purpose which would have rendered it, to the extent that it is subject to such power, not deductible had it been directly so bequeathed, devised, or given by the decedent, deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of such power. (Reg. 63, Art. 50.)

The deduction may be claimed by the estates of all decedents dying after December 31, 1917. Where the tax has been paid without taking the deduction, a claim for refund may be made, as provided by Article 96. (Reg. 63, Art. 51.)

The foregoing regulations are a great improvement over Regulations 37, which they superseded on July 27, 1922, and

which included a very objectionable provision[52] denying exemption to a bequest to a religious corporation which owns and works a farm or manufactures and sells articles for profit, as not being operated exclusively for religious purposes, even though its property is held in common and its profits do not inure to the benefit of individual members of the corporation. This regulation [Regulation 37, article 54 (2)] has been omitted entirely from the new regulations.

It is difficult, however, to see for what reason contributions to community chests, funds, or foundations are not included in the deductions under this title. For income tax purposes[53] they are specifically enumerated among the deductions allowed to individuals. This is an invidious distinction as between the treatment of contributions donated by an individual himself and those donated by his executor in accord with his expressed desires before his death.

Specific exemption.—The 1921 law makes no change in the specific exemption of $50,000 allowed in the case of resident estates. This exemption has been allowed in all laws from 1916.

LAW. Section 403. **That for the purpose of the tax the value of the net estate shall be determined—**

(a) In the case of a resident, by deducting from the value of the gross estate— . . . .

(4) An exemption of $50,000; . . . .

REGULATION. There may be deducted from the gross estate of all resident decedents a specific exemption of $50,000. No such exemption is allowed in the estates of nonresident decedents. If more than one return is made for purposes of the tax, the exemption may be taken but once. (Reg. 63, Art. 52.)

Two Months' Notice

Resident estates.[54]—In the case of a resident decedent, action is required on the part of the executor before the regu-

[52] See the author's comments on pages 1482 and 1483 of *Income Tax Procedure*, 1922.

[53] Title II, section 214 (a-11).

[54] For non-residents see page 1464.

lar return is filed. It is necessary that he give written notice to the collector in the district wherein the decedent died of such death, of the approximate amount of the gross estate and of his appointment by the court or of his coming into possession of the property. This notice must be filed within two months after the executor has had his appointment confirmed by the courts.

LAW. Section 404. **That the executor, within two months after the decedent's death, or within a like period after qualifying as such, shall give written notice thereof to the collector. . . . .**

NOTICE BY EXECUTOR OR ADMINISTRATOR.—

REGULATIONS. A preliminary notice[55] is required to be filed in the case of every resident decedent whose gross estate exceeded $50,000 in value at date of death. This notice must be filed in duplicate with the collector in whose district the decedent had his domicile at the time of death. Where there is doubt as to whether the gross estate exceeds $50,000, the notice should be filed, as a matter of precaution, in order to avoid penalties. (Reg. 63, Art. 60.)

The duly qualified executor or administrator is required to file such preliminary notice on Form 704, copies of which may be obtained from the collector, within two months after qualifying as such, if notice has not already been filed. The primary purpose of the notice is to advise the Government of the existence of taxable estates, and filing should not be delayed beyond the two-months period because of uncertainty as to the exact value of the assets. Since the filing of the notice within the prescribed period is mandatory, the estimate of the gross estate called for by the notice is merely the best approximation of value which can be made within the time allowed. The instructions upon the back of the form should be read carefully before executing the notice. The signature of one executor or administrator upon Form 704 is sufficient. For penalties for delinquency in filing notice, or for filing a false or fraudulent notice, see Articles 88 to 90, inclusive. (Reg. 63, Art. 61.)

A detailed explanation under oath must accompany form

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[55] **[Former Procedure]** Prior regulations required the preliminary notice to be filed within 60 days, and called it the 60-day notice. The new regulations prescribe the time as two months, but the designation "60-day notice" is still popularly used.

Prior to February 25, 1919, the notice was required if the gross estate exceeded $60,000, or if there was any net estate after the deductions allowed by law, including the $50,000 exemption, had been taken. These provisions are not now in effect except to determine delinquency under previous acts.

704 in the event of failure to file the form within the time set by law.

Notice by others than the executor or administrator.—

Regulation. The term "executor" embraces any person in actual or constructive possession of any property of the decedent at the time of the latter's death, where there is no duly qualified executor or administrator. The notice on Form 704 must be filed by such persons in every case where an executor or administrator has not duly qualified as such within two months next following the decedent's death. Where, however, an executor or administrator qualifies within such period, the duty of filing the notice devolves upon him, and all other persons are relieved therefrom. (Reg. 63, Art. 62.)

The prior regulations specified in considerable detail the persons besides executors or administrators required to give the 60-day notice, and included insurance companies paying insurance upon the life of a resident decedent to beneficiaries other than the executor or administrator in amounts aggregating more than $40,000. Article 62 of the new Regulations 63 is comprehensive enough to include all persons having possession of any property of the decedent, and no mention is made of insurance companies. The question of the liability of insurance companies in the circumstances is thus very properly left dependent on the determination of whether such insurance was in any sense the property of the decedent at the time of his death.

When military exemption claimed, two months' notice nevertheless required.—

Regulation. The executors of estates claiming the right to exemption from the tax under the provisions of Section 401 (see Art. 9), are required to file the two-months notice with the proper collector in the same manner as the executors of taxable estates. The executor should, in addition, write across the face of the form the words "Exemption claimed on account of military service." (Reg. 63, Art. 63.)

Under the provision covering military exemptions (section 401) the regulations demand that a formal claim for such

exemption be submitted with the two months' notice, or as soon as possible thereafter, on form 793.[56]

Returns

Returns for resident estates.—As with returns called for under the income tax laws, the returns under this title literally impose upon the executor the duty of assessing the amount of tax due. The correctness of this assessment is subject to final determination by the Commissioner.

The form of the return is practically a series of information schedules which may be summarized as follows:

1. General information sheet in regard to decedent, heirs, legatees, and beneficiaries.
2. Items under separate captions, going to make up the gross estate (schedules A to D).
3. Transfers, property passing under power of appointment, and property taxed within five years (schedules E to G).
4. Deductions classified (schedules H to K).
5. Recapitulation (schedule L).
6. Rates and tax due (schedule M).
7. Jurat for executors, etc.

Schedule M also calls for details to be supplied by nonresidents as to gross estate situated outside the United States.

Explicit and concise instructions are given regarding the information required, and these instructions should be followed in every particular.

LAW. Section 404. . . . . The executor shall also, at such times and in such manner as may be required by regulations made pursuant to law, file with the collector a return under oath in duplicate, setting forth (a) the value of the gross estate of the decedent at the time of his death, or, in case of a nonresident, of that part of his gross estate situated in the United States; (b) the deductions allowed under section 403; (c) the value of the net estate of the decedent as defined in section 403; and (d) the tax paid or payable there-

[56] Reg. 63, Art. 10.

on; or such part of such information as may at the time be ascertainable and such supplemental data as may be necessary to establish the correct tax.

Return shall be made in all cases where the gross estate at the death of the decedent exceeds $50,000, and in the case of the estate of every nonresident any part of whose gross estate is situated in the United States. If the executor is unable to make a complete return as to any part of the gross estate of the decedent, he shall include in his return a description of such part and the name of every person holding a legal or beneficial interest therein, and upon notice from the collector such person shall in like manner make a return as to such part of the gross estate. The commissioner shall make all assessments of the tax under the authority of existing administrative special and general provisions of law relating to the assessment and collection of taxes.

Date of filing return.—

Regulation. A return on Form 706 is required in the case of every resident decedent whose gross estate, as defined in the statute, exceeded $50,000 in value. This return must be filed with the collector for the district in which the decedent was domiciled at the time of his death. It must be filed in duplicate within one year after the date of death. When the due date for filing the return, Form 706, falls on a Sunday or on a legal holiday, the due date for filing will be the day following such Sunday or legal holiday.

Extension of time for filing return.—

If it is impossible for the executor to file a reasonably complete return within one year from the date of death, the Commissioner may, upon application from the executor showing good and sufficient cause, grant extensions of time not to exceed a total of 180 days from the due date, and no single extension to exceed 60 days. At the expiration of the last extension period granted, a return as complete as possible must be filed, and the executor may thereafter file an amended return when the condition of the estate permits. An extension of time for filing the return does not operate to extend the time for the payment of the tax, which is due one year after the decedent's death unless an extension of time in which to make payment has been obtained as provided in article 82. (Reg. 63, Art. 67.)

Who shall make the return.—

Regulation. The statute provides that the duly qualified executor or administrator shall file the return. If there is more than one executor or administrator, the return must be made jointly by all. Where no executor or administrator has been appointed, every person in actual or constructive possession of any property of the decedent

is constituted by the statute an executor for the purpose of the tax, and is required to make and file a return as provided by Section 404. Where, in any case, the executor is unable to make a complete return as to any part of the gross estate, he is required to give all the information he has as to such property, including a full description, and the name of every person holding a legal or beneficial interest in the property. Where the executor is unable to make a return as to any property, the statute requires every person holding a legal or beneficial interest therein, upon notice from the collector, to make return as to such part of the gross estate. For penalties for delinquency in filing return, or for filing a false or fraudulent return, see Articles 88 to 90, inclusive. (Reg. 63, Art. 68.)

Form of return.—

Regulations. The return must be made on Form 706, copies of which will be supplied by the collector. It must contain an itemized inventory, by schedule, of the property constituting the gross estate, and of the deductions. The instructions printed on the form should be carefully followed. All documents and vouchers used in preparing the return should be retained by the executor, so as to be available for inspection whenever required. Duplicate certified copies of the will, if any, must be submitted with the return, together with duplicate copies of the other documents required by the instructions printed on the form, or any documents which the executor may desire to submit with the return in explanation thereof. (Reg. 63, Art. 69.)

The statute provides that the executor, in addition to filing notice and return, shall furnish such supplemental data as may be necessary to establish the correct tax. It is therefore the duty of the executor to furnish upon request copies of any documents in his possession relating to the estate, or on file in any court having jurisdiction over the estate, appraisal lists of any items included in the gross estate, copies of balance sheets or other financial statements relating to the value of stock, and any other information obtainable by him that may be found necessary in the determination of the tax. Failure to comply with such a request will render the executor liable to a fine not to exceed $500, and proceedings may be instituted in the proper United States court to secure compliance therewith. (See Sections 410 and 404.) (Reg. 63, Art. 70.)

Procedure where no return has been made.—

Regulation. Section 405 of the statute provides that if no return is filed for the estate of a decedent, or if a return contains a false or incorrect statement of a material fact, the collector or deputy collector shall make a return. The Commissioner may amend this return from

such knowledge or information as he can obtain, through testimony or otherwise. A return so made by the Commissioner, or made by the collector or deputy collector, is a sufficient basis for assessing the tax. Where a tax is found to be due upon such a return, both the estate and the executor will be liable for penalties as well as for the tax. (Reg. 63, Art. 71.)

Investigation of returns.—In view of the fact that many months may elapse between the determination of values for inclusion in the gross estate and their inevitable review by an officer of the Internal Revenue Bureau[57] it is necessary that all calculations and methods of computation used should be carefully preserved in a manner that will permit of easy reference. This is, indeed, called for by the Treasury,[58] but that it is essential, even apart from the Treasury requirements will be readily recognized by an executor who has to make good his estimates to the investigating officer at any time after they have been made. It would be well for all parties concerned if this lapse of time could be shortened so that administration of the decedent's estate could be speedily concluded and a distribution to the legatees made. Apparently, unnecessary expense and hardship is involved under existing conditions. A suggestion that a final assessment of the tax be made within sixty days of the filing of the return, presented to the Committee on Ways and Means prior to the passing of the Revenue Act of 1918, produced no tangible reform in this direction.

Consideration of the regulation below shows exactly how far the suggestion was acted on, taking the expression "as soon as practicable" at its putative worth in so far as the Department of Internal Revenue is concerned. The provision of the regulation which allows an executor to secure within a year, if he applies for it, a discharge from personal liability for any additional estate tax which may be found due upon the final auditing of his return is, however, a step in the right direction. This is a new provision in Regulations 63 which were ap-

[57] Reg. 63, Art. 72.
[58] Reg. 63, Art. 103.

proved July 27, 1922. It is to be noted that the Commissioner is not obliged by this change to make a final determination of the tax within one year, so far as the estate itself is concerned, but only such a determination as will enable him to discharge the executor personally. It is quite possible that a subsequent investigation may result in the imposition of additional taxes, which the Commissioner would have authority to collect from the estate, in the hands of the executor or from the distributees if the executor has distributed it.

Regulations. An investigation of every return for estate tax will be conducted to verify its accuracy. The investigation will be made by special officers of the Bureau. The fact that an investigation is made does not reflect upon the competence or good faith of the executor, since investigations are required in all cases. The executor should cooperate with the examining officer in order that the tax liability may be correctly determined and the case closed. During the course of the investigation the examining officer will inspect the books and records of the estate, interview the executor and other persons having knowledge of the decedent's affairs, verify the value of the assets and the deductions, and take such other steps as may be necessary in order that the correct amount of tax may be determined.

Upon completion of the investigation the executor will be apprised by the examining officer of his findings, and will be given an opportunity to discuss the case and present such data as he may desire the Commissioner to consider in connection with the examining officer's report. Upon the completion of a review and audit by the Commissioner, the executor will be informed by letter of the result thereof. If the letter contains notification of an amount of unpaid tax, such unpaid amount should be remitted promptly to the collector, and if not paid within the time specified by the applicable provisions of section 406 or section 407, interest will be added as required thereby. (See Art. 83.)

It is the purpose of the Commissioner to make these investigations as soon as practicable after the filing of the return. Where the executor files a *complete* return, and makes written application to the Commissioner for a determination of the tax and discharge from personal liability therefor, the Commissioner will, within one year after receipt of such application, notify the executor of the amount of the tax, and, upon payment thereof, the executor will be discharged from personal liability for any additional estate tax thereafter found to be due. (See Sec. 407.) This provision applies also to cases arising under the Revenue Act of 1918. Attention is here directed to Section 250 (d) of the statute which embodies a provision, "That

in the case of *income* received during the lifetime of a decedent, all taxes due thereon shall be determined and assessed by the Commissioner within one year after written request therefor by the executor, administrator, or other fiduciary representing the estate of such decedent: . . . ." (Reg. 63, Art. 72.)

It is the duty of the executor to keep such records as the Commissioner may require. Executors are required to keep such complete and detailed records of the affairs of the estate as will enable the Commissioner to determine accurately the amount of the tax liability. (Reg. 63, Art. 103.)

Promise of more speedy operation on the part of the sections responsible for audit and examination of estate tax returns is reflected in the statement that "changes in procedure and personnel have resulted in bringing work to a current basis and increased efficiency." There were 13,192 estate tax returns filed during the year ended June 30, 1922, which produced over $114,600,000. Examinations during the year of returns disclosed additional taxes due to the government amounting to over $13,600,000, or 11.9 per cent, an indication of the necessity for prompt audit so that executors may close estates within a reasonable time.

Returns confidential.—

Regulations. All estate tax returns and notices are treated as privileged communications and may not be exhibited to any person other than the executor or his duly authorized agent, except as stated in Article 76. This requirement of secrecy will be rigidly enforced, and extends to information of a private nature submitted or obtained in connection with a return or notice. The requirement does not operate to prevent internal revenue officers from disclosing the returned value of any item or the amount of any specific deduction where such disclosure is necessary in order to arrive at a correct determination of the tax. This right of disclosure, however, does not extend to such information as the amount of the estate, the amount of tax, or other general data. Nor are the records in possession of the Bureau, whether on file with the Commissioner or the collector, open to inspection, except as provided in Article 76. (Reg. 63, Art. 75.)

Where any person other than the executor has a material interest in ascertaining any fact disclosed by the return, or in obtaining information as to the payment of the tax, he shall make a written applica-

tion to the Commissioner of Internal Revenue for such information, setting forth the nature of his interest and the purpose of the application. The Commissioner will review the application, and, if it is approved, the collector will be directed to exhibit the return to the applicant, or give him such information as is specified, or the Commissioner may permit an inspection of the return on file in the Bureau, or furnish such information as he deems advisable. Under no circumstances shall the collector give information to persons other than the executor except upon the written order of the Commissioner, and then only to the extent authorized by such order. (Reg. 63, Art. 76.)

In all cases where information is sought regarding an estate, or an interview asked, by an attorney whose name does not appear on Form 706 as the attorney for the estate, or by any agent of the executor or administrator, the information or interview will be denied unless the attorney or agent presents a signed statement from the executor or administrator authorizing him to act in his behalf. Where his name as attorney for the estate appears on Form 706, his identity must be established. If an attorney or other person asks a ruling on a question of law arising in a specific estate, the Commissioner may require satisfactory evidence of the right to obtain such ruling.

For regulations governing the recognition of attorneys, agents, and other persons representing claimants and executors before the Treasury Department, reference should be made to Treasury Department Circular No. 230, dated April 25, 1922, copies of which may be obtained on application to the chief clerk of the Treasury Department. (Reg. 63, Art. 77.)

Return by collector.—

Law. Section 405. **That if no administration is granted upon the estate of a decedent, or if no return is filed as provided in section 404, or if a return contains a false or incorrect statement of a material fact, the collector or deputy collector shall make a return and the Commisioner shall assess the tax thereon.**[59]

Regulation. Where there is no duly qualified executor or administrator, or no return is filed within one year after the decedent's death, or if a filed return contains a false or incorrect statement of a material fact, the collector or deputy collector may make a return from such information as he possesses or is able to obtain. The Commissioner may also make a return in such cases, or amend any return made by a collector or deputy collector, and any return so made or amended, or made by a collector or deputy collector and approved by the Commissioner, shall be prima facie good and sufficient for all legal purposes, and the Commissioner will assess the tax in the same

[59] See also section 1311, page 87.

manner as though the return had been filed by the person on whom the duty to make the return rested. (Reg. 63, Art. 78.)

Payment of Tax

When tax due and payable.—In contradistinction to payments required in the case of income and excess profits taxes, the amount of an estate tax is not payable in instalments but in full one year after the date of the decedent's death. In view of the fact that the payment is made directly out of the corpus of the decedent's estate, there would be little reason for the spreading of such payment over any particular period. Should it happen that the selling of property or securities, in order to liquidate the liability at one certain time, would obviously be detrimental to the estate, and an extension of time might mean an alleviation of this hardship, the law empowers the Commissioner to grant such an extension up to a period of three years. Whether extension be granted or not, any tax due and not paid within one year and six months after date of decedent's death will be subject to interest at the rate of 6 per cent per annum from the date when the whole tax was originally due and payable.

Law. Section 406. **That the tax shall be due and payable one year after the decedent's death; but in any case where the Commissioner finds that payment of the tax within such period would impose undue hardship upon the estate, he may grant an extension or extensions of time for payment not to exceed three years from the due date.**

The executor shall pay the tax to the collector or deputy collector, and to such portion of the tax, not paid within one year and six months after the decedent's death, interest at the rate of 6 per centum per annum from the expiration of one year after such death shall be added as part of the tax irrespective of any extension or extensions of time that may have been granted for the payment of the tax, or any portion thereof.

Regulations. The provisions relating to rates and payment of the tax are the same in estates of nonresidents and of residents. The statute provides that the executor shall pay the tax. If no executor or administrator has been appointed, every person in either the actual or constructive possession of any property of the decedent is consti-

tuted by the statute an executor for the purpose of tax payment, and is liable for the tax to the extent of the property so in his possession. All checks, drafts, or money orders should be made payable to the order of Collector of Internal Revenue. (See Arts. 79 to 83, inclusive.) (Reg. 63, Art. 59.)

While no interest may be added to the tax unless payment thereof has not been made within one year and six months after decedent's death, the tax itself is due and must be paid within one year after the decedent's death unless an extension of time for the payment thereof has been granted by the Commissioner. No discount will be allowed for payment in advance of the due date. The collector will grant to the person paying the tax duplicate receipts, either of which will be sufficient evidence of such payment, and entitle the executor to be credited with the amount by any court having jurisdiction to audit or settle his accounts.

Payment of the amount of tax shown to be due by a return made in good faith will be considered payment of the tax in full, subject, however, to adjustment resulting from an investigation of the estate. If the return is not made in good faith, the payment of the amount of tax shown to be due thereby will not be deemed to be payment in full of the tax, but interest will attach, and penalties will be imposed, as set forth in articles 83 and 89.

Following an investigation of the estate the tax liability will be finally determined by the Commissioner upon the basis of such investigation. If at the time the Commissioner's determination is made the tax has been paid upon the basis of the return, an adjustment will be made of the amount of tax. If the amount of tax already paid exceeds the amount of tax as finally determined, the Commissioner will refund such excess. If the amount of tax as finally determined exceeds the amount of tax already paid, the collector will notify the executor of the amount of the unpaid balance of the tax and demand payment thereof. Payment should be made by the executor immediately upon the receipt of such notification. Where the investigation of the return shows that no further tax is due, the executor will be notified to that effect. Until the receipt of such notification, he should reserve a sufficient portion of the estate to satisfy any additional tax. (Reg. 63, Art. 79.)

The tax is due and payable one year after decedent's death (section 406). Under the foregoing section, proceedings for the collection of the amount due may be instituted directly thereafter. The same section in the 1918 law allowed a period of grace for payment to the extent of 180 days after the due date. In one case it was desired to take advantage of this sec-

tion and the collector, ignoring section 408 of the 1918 law and justifying his action under Revised Statutes, section 3157, permitting distraint for recovery of taxes ten days after notice and demand, threatened immediately to distrain unless tax was paid in full. The 180-day period did not elapse for a further four months. The collector's right to collect under distraint was denied him.[60] The reference to 180 days' extension after the due date is omitted in the 1921 law.

Payment of tax under protest.—In case an executor or administrator believes that the tax as finally determined and assessed by the Commissioner is erroneous, unjust and excessive, his remedy is to pay the tax under protest and subsequently, if necessary, bring suit against the collector to recover the tax paid. This remedy is exclusive, and no other remedy can be substituted for it. Before beginning suit, however, every effort should, of course, be made to secure a refund by proper application therefor. In the case of *Nichols v. Gaston,*[61] the United States Circuit Court of Appeals for the First Circuit decided (March 21, 1922)as follows in denying the executors of a will an injunction to restrain him from collecting an estate tax.

Decision. . . . The remedy of a suit to recover back the tax after it is paid is provided by statute, and a suit to restrain its collection is forbidden. The remedy so given is exclusive, and no other remedy can be substituted for it . . . .

The following is from the syllabus of the above case, as it appears in T. D. 3325.

. . . . Section 3220, Revised Statutes, as amended by section 1316 (a) of the Revenue Act of 1918, authorizes the Commissioner of Internal Revenue to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, and also all damages and costs recovered against any collector in any suit brought against him by reason of anything done in due performance of his official duty. Complainants, as executors of an estate, brought suit against a col-

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[60] *Polk et al. v. Page*, 276 Fed. 128. However, the decision was reversed on appeal, C. C. A. 1st Cir., May 16, 1922.

[61] 281 Fed. 67.

lector of internal revenue to restrain collection of an estate tax on the ground that under section 408 of the Revenue Act of 1918 they had until the expiration of 180 days after such tax became due to pay same, and alleged that they were without adequate remedy at law. Held, that had complainants paid the tax under protest when demanded, they could have recovered judgment against the collector for damages sustained, if collection was premature and they were thereby damaged; that in view thereof and the further facts that under the law they would have been entitled to interest on such damages down to entry of final judgment, and that, upon a certificate of probable cause, under section 989 of Revised Statutes, the liability of the Government to pay the judgment would attach, complainants had a legal remedy, and, irrespective of the inhibition in section 3224 of the Revised Statutes against suits to restrain assessment or collection of any tax in any court, injunction would not lie to restrain the collection of the tax, though interest on the judgment, after it became final, would not run against the Government.

The inhibition in section 3224, Revised Statutes, against suits to restrain assessment or collection of any tax in any court, applies to all assessments or collections of internal revenue taxes made or attempted to be made under color of office by internal revenue officers charged with general jurisdiction over assessment and collection of such taxes, and, if the Commissioner of Internal Revenue, in assessing a tax or the collector in collecting it, acts under color of office, such section applies and no suit to restrain the assessment or collection of the tax can be maintained. . . . . (C. B. I-1, page 461; T. D. 3325.)

Payment of tax in United States bonds.—

Regulation. Payment of the estate tax may be made with bonds or notes (including Victory Notes and Treasury Notes) of the United States bearing interest at a higher rate than 4 per centum per annum, provided they were owned by the decedent continuously for at least six months prior to the date of his death, and constituted a part of his estate at death. Such bonds and notes are receivable at par and interest accrued at the time of the payment. When such bonds or notes are to be tendered in payment of estate taxes, a copy of Department Circular No. 225, as heretofore or hereafter amended or supplemented, should be procured and the requirements thereof carefully noted. . . . . (Reg. 63, Art. 80.)

The use of Liberty bonds or Treasury Notes for payment of the estate tax will prove advantageous where such bonds or notes are selling below par. In any case in which it is proposed to pay the tax in Liberty bonds, reference should be made to Department Circular 225, dated January 31, 1921,

and a supplemental circular dated June 30, 1922, containing detailed instructions which are too lengthy to reproduce here. The computation of accrued interest is to be made in accordance with the tables issued with the circulars referred to.

Payment of tax by uncertified check.—Uncertified checks, if collectible at par, may be accepted in payment of the estate tax. The regulation is permissive, not mandatory.

Regulation. . . . . Collectors may accept uncertified checks in payment of estate taxes, provided such checks are collectible at par, that is, for the full amount, without any deduction for exchange or other charges. The collector will stamp upon the face of each check before deposit thereof the words "This check is in payment of an obligation to the United States and must be paid at par. No protest," with his name and title. The day on which the collector receives the check will be considered the date of payment so far as the taxpayer is concerned, unless the check is returned dishonored. If the bank on which any such check is drawn should refuse to pay it at par, the check should be returned through the depositary bank and be treated in the same manner as a bad check. All expenses incident to the attempt to collect such a check and the return of it through the depositary bank must be paid by the drawer of the check to the bank on which it is drawn, since no deduction can be made from amounts received in payments of taxes. . . . . If any taxpayer whose check has been returned uncollected by the depositary bank should fail at once to make the check good, the collector should proceed to collect the tax as though no check had been given. A taxpayer who tenders a certified check in payment of taxes is also not released from his obligation until the check has been paid. . . . .

Treasury Department Circular No. 176, as amended, prescribes detailed regulations governing the deposit and collection of checks. Collectors are referred to paragraphs 13-16 and paragraph 26 thereof as to the deposit of taxpayers' checks and the handling of uncollected or lost items. (Reg. 63, Art. 80.)

Who shall pay the tax?—The tax is paid by the executor. The mode of payment has already been fully discussed in this chapter, but a provision in the 1921 law whereby the executor can be freed from his responsibility under certain circumstances calls for further comment. This relief provision is more apparent than real. Under the rule laid down in the statute he cannot get the promised relief until the Com-

missioner has notified him of the amount of the tax, and such tax has been paid. Further, the Commissioner is permitted to take *one year* in which to furnish this information. In other words, the executor has to await the examination of his original return, the reassessment, if any, arising out of such examination, and the payment of the amount of any additional tax, before he can obtain his release, all of which proceedings may occupy a year to carry out. By the time he is relieved of his liability his executorship duties, in the majority of instances, would have terminated and the liability for any further tax thereafter found to be due would be held against the beneficiaries, to the extent of their interests in the original estate.

REGULATION. The statute provides that the executor or administrator shall pay the tax. This duty applies to the entire tax, regardless of the fact that the gross estate consists in part of property which will not come into his possession. Where there is no duly qualified executor or administrator, all persons in actual or constructive possession of any property of the decedent are liable for and required to pay the tax to the extent of the value of such property. See also, Article 86. As to the personal liability of the executor, see Article 99. (Reg. 63, Art. 81.)

The following statute and regulation cover the personal liability of the executor for the payment of the tax.

LAW. Revised Statutes, Sec. 3467 (Comp. Sts., 1916, Sec. 6373.) **Every executor, administrator, or assignee, or other person, who pays any debts due by the person or estate for whom or for which he acts, before he satisfies and pays the debts due to the United States from such person or estate, shall become answerable in his own person and estate for the debts so due to the United States, or for so much thereof as may remain due and unpaid.**

REGULATION. The executor is personally liable for the payment of the estate tax to the amount of the full value of the assets of the estate which have at any time come into his hands. Where no executor or administrator has been appointed, every person in actual or constructive possession of any property of the decedent is liable for the tax as an executor to the value of such property, except as limited by Article 86 in the case of transferees, trustees and insurance beneficiaries. (Reg. 63, Art. 99.)

See also section 408 of the present law, and article 102 of Regulations 63, quoted on page 1446.

Extension of time for payment.—

Regulation. In any case where the Commissioner finds that payment of the tax within one year after the decedent's death would impose undue hardship upon the estate, an extension or extensions of time will be granted by him for the payment of the tax for a period not to exceed in all three years from the due date. Extensions of time for tax payment will be granted only in exceptional cases, where it is evident that the payment of the tax within the statutory period would cause the estate serious financial loss. No single extension for more than one year will be granted. Application for extension of time for payment should be filed with the collector, and should contain a full statement of the facts upon which the application is based. The collector will refer the application to the Commissioner, with suitable recommendations.

An extension of time to pay the tax does not relieve from the duty of filing the return within one year from the date of death, nor will it operate to prevent interest from accruing as provided in the statute. (Reg. 63, Art. 82.)

Interest on tax.—

Regulation. Sections 406 and 407 contain the only provisions relating to interest on estate tax and consequently all questions of this character must be determined in accordance therewith. Section 407 deals with interest upon *additional* tax, and applies only to cases where the amount of tax shown upon a return made in good faith is fully paid within one year and six months after decedent's death, or time for payment of any portion thereof is extended beyond such period, and where after the lapse of such year and six months, the Commissioner determines that the correct amount of tax is in excess of that indicated by such return. The additional tax so determined, if not paid within one month after notice and demand by the collector, bears interest at the rate of 10 per centum per annum from the expiration of such time until payment is received by the collector.

All other cases fall within, and are governed by, the provisions of Section 406. Thus, where any portion of the tax shown upon a return made in good faith is not paid within one year and six months following decedent's death, interest accrues thereon, though an extension of time for payment may have been granted, at the rate of 6 per centum per annum from the due date (one year after decedent's death) until payment is received by the collector. Likewise, in the case of a return so made and where no extension of time for payment is granted, so much of the entire tax (that is, the amount of tax as finally determined by the Commissioner, whether determined by him before or after the expiration of such period of one year and six months following the decedent's death, and whether the amount so

determined be greater or less than that shown upon the return) as is not paid within such period bears interest at the rate of 6 per centum per annum from the due date until payment is received by the collector.

Where the return is not made in good faith, Section 407 has no application, even though an extension of time may have been procured, and hence in all such cases any portion of the entire tax not paid within such period of one year and six months following decedent's death bears interest at the rate of 6 per centum per annum from the due date of the tax (one year after decedent's death) until payment thereof is received by the collector. (Reg. 63, Art. 83.)

Collection of Tax

LAW. Section 408. **That if the tax herein imposed is not paid on or before the due date thereof the collector shall, upon instruction from the Commissioner, proceed to collect the tax under the provisions of general law, or commence appropriate proceedings in any court of the United States, in the name of the United States, to subject the property of the decedent to be sold under the judgment or decree of the court. From the proceeds of such sale the amount of the tax, together with the costs and expenses of every description to be allowed by the court, shall be first paid, and the balance shall be deposited according to the order of the court, to be paid under its direction to the person entitled thereto. . . . .**

REGULATIONS. The remedy by action, here provided, is not exclusive. For other available remedies for the collection of the tax, see Article 102. (Reg. 63, Art. 84.)

The provisions of the statute quoted above apply to the estate tax law; and three remedies are thus provided for the collection of the tax:

(1) *Collection by distraint.*—The collector may issue warrant of distraint authorizing the seizure and sale of any or all of the assets of the estate. (See R. S., Secs. 3187 et seq.; Comp. Sts., 1916, Sec. 5909 et seq.)

(2) *Collection by suit to subject the property to sale.*—The collector may commence in any court of the United States appropriate proceedings, in the name of the United States, to subject the property of the decedent to sale under the judgment or decree of the court.

(3) *Collection by suit for personal liability.*—The personal liability of the executor, of the transferee or trustee of property transferred in contemplation of or intended to take effect in possession or enjoyment at or after decedent's death, and of the beneficiary of life insurance, may be enforced by any appropriate action. (Reg. 63, Art. 102.)

Reimbursement.—

LAW. Section 408. . . . . If the tax or any part thereof is paid by, or collected out of that part of the estate passing to or in the possession of, any person other than the executor in his capacity as such, such person shall be entitled to reimbursement out of any part of the estate still undistributed or by a just and equitable contribution by the persons whose interest in the estate of the decedent would have been reduced if the tax had been paid before the distribution of the estate or whose interest is subject to equal or prior liability for the payment of taxes, debts, or other charges against the estate, it being the purpose and intent of this title that so far as is practicable and unless otherwise directed by the will of the decedent the tax shall be paid out of the estate before its distribution. If any part of the gross estate consists of proceeds of policies of insurance upon the life of the decedent receivable by a beneficiary other than the executor, the executor shall be entitled to recover from such beneficiary such portion of the total tax paid as the proceeds, in excess of $40,000, of such policies bear to the net estate. If there is more than one such beneficiary the executor shall be entitled to recover from such beneficiaries in the same ratio.

REGULATION. Where any portion of the tax is paid by, or collected out of that part of the estate passing to, or in the possession of, any person other than the duly qualified executor or administrator, such person may be entitled to reimbursement, either out of the undistributed estate or by contribution from other beneficiaries whose shares or interests in the estate would have been reduced had the tax been paid before distribution of the estate, or whose shares or interests are subject either to an equal or prior liability for the payment of taxes, debts, or other charges against the estate. The executor is also entitled to require beneficiaries under insurance policies to bear their proportion of the tax. These provisions, however, are not designed to curtail the right of the Commissioner to collect the tax from any person, or out of any property, liable therefor. The Commissioner can not be required to apportion the tax among the persons liable, nor to enforce any right to reimbursement or contribution. For example, where a transfer has been made in contemplation of death, the Commissioner may hold both the executor and the transferee liable for the tax with respect to the property transferred. In such case, if the tax is paid by the executor, he may not look to the Commissioner for relief by refund of part of the tax. (Reg. 63, Art. 85.)

Unpaid tax a lien on estate.—

LAW. Section 409. That unless the tax is sooner paid in full, it shall be a lien for ten years upon the gross estate of the decedent, except that such part of the gross estate as is used for the payment

of charges against the estate and expenses of its administration, allowed by any court having jurisdiction thereof, shall be divested of such lien. If the Commissioner is satisfied that the tax liability of an estate has been fully discharged or provided for, he may, under regulations prescribed by him with the approval of the Secretary, issue his certificate releasing any or all property of such estate from the lien herein imposed. . . . .

REGULATION. This lien attaches to every part of the gross estate, whether or not the property comes into the possession of the duly qualified executor or administrator. It attaches to the extent of the tax shown to be due by the return and of any additional tax found to be due upon investigation. . . . . (Reg. 63, Art. 86.)

Liability of transferee and insurance beneficiary.—Though property may have passed into the possession of a beneficiary through the medium of a trust made in contemplation of death or to take effect at or after death of decedent, and even in the case of insurance passing under contract to a specific beneficiary[62] the property or proceeds are subject to a lien to secure payment of taxes due, to the extent of the decedent's interest therein at the time of transfer.

LAW. Section 409. . . . . If (a) the decedent makes a transfer of, or creates a trust with respect to, any property in contemplation of or intended to take effect in possession or enjoyment at or after his death (except in the case of a bona fide sale for a fair consideration in money or money's worth) or (b) if insurance passes under a contract executed by the decedent in favor of a specific beneficiary, and if in either case the tax in respect thereto is not paid when due, then the transferee, trustee, or beneficiary shall be personally liable for such tax, and such property, to the extent of the decedent's interest therein at the time of such transfer, or to the extent of such beneficiary's interest under such contract of insurance, shall be subject to a like lien equal to the amount of such tax. Any part of such property sold by such transferee or trustee to a bona fide purchaser for a fair consideration in money or money's worth shall be divested of the lien and a like lien shall then attach to all the property of such transferee or trustee, except any part sold to a bona fide purchaser for a fair consideration in money or money's worth.

REGULATION. . . . . Where the decedent transferred or placed in trust property in contemplation of or intended to take effect in possession or enjoyment at or after his death (except in the case

[62] See page 1410 *et seq.*

of a bona fide sale for a fair consideration in money or money's worth), and where proceeds of insurance on his life passed to a specific beneficiary other than the duly qualified executor or administrator, a lien attaches thereto to the amount of the tax in respect to the particular property or money received by such transferee, trustee, or insurance beneficiary, and such transferee, trustee, or insurance beneficiary is personally liable for such tax.

Where the transferee or trustee sells the property to a bona fide purchaser for a fair consideration in money or money's worth the lien upon the property is divested; but there is substituted a like lien upon all the property of such transferee or in case of such transfer by a trustee upon all the assets of the trust estate, except such part as may be sold to a bona fide purchaser for such a consideration.

The lien upon the entire property constituting the gross estate continues for a period of 10 years after the decedent's death, except—

(1) Where the tax is paid in full before the expiration of such period;

(2) Such portion of the gross estate as is used for the payment of charges against the estate and expenses of its administration allowed by any court having jurisdiction thereof;

(3) Such portion of the gross estate as has passed to a bona fide purchaser for value after payment of the full amount of tax determined by the Commissioner pursuant to a request of the executor, as authorized by Section 407, for discharge from personal liability (see Art. 72);

(4) Such property as has been sold by any transferee or trustee to a bona fide purchaser for a fair consideration in money or money's worth, where such property was received from the decedent as a transfer in contemplation of, or intended to take effect in possession or enjoyment at or after, his death (except in the case of a bona fide sale for a fair consideration in money or money's worth);

(5) Where the Commissioner issues his certificate releasing such lien (see Art. 87). (Reg. 63, Art. 86.)

The question of the taxability of insurance in favor of a third party has already been discussed in this chapter.[63] The right of recovery against the beneficiary, allowed the executor under section 408, in the case of the tax on such portion of the benefits received by him in excess of $40,000, inflicts a direct tax on the beneficiary which is not in keeping with the general character of the tax imposed by the law. If an individual were bequeathed $50,000, he would receive the $50,000,

[63] See page 1410 *et seq.*

provided there was sufficient residual property out of which the estate tax could be paid. In the case of an insurance policy in favor of a beneficiary for a like sum, the executor is given the power to collect the portion of tax applicable thereto from such beneficiary, irrespective of whether or not there is a sufficient residual estate to meet the demands of the tax. The rate at which a beneficiary, under these circumstances, would be taxed at the will of the executor, must necessarily be an arbitrary one dependent entirely upon the bracket which the final amount of the decedent's net estate reaches. An individual is interested to the extent of $3,000 insurance benefit in total benefits of this nature aggregating $100,000; the net estate amounts to $3,000,000. He is taxed 15.38 per cent on $2,000, i.e., 40/60 of his benefit. The amount of his legacy would be impaired to the extent of $307.60, or more than 10 per cent. Apart from any question of the legality of taxing proceeds from third party insurance, this provision not only works a hardship and imposes a direct tax on the beneficiary, but also has a further fault; the amount by which the beneficiary's legacy is reduced depends entirely on the total net estate of the decedent. This is an obviously unfair way of basing a tax on a beneficiary who has no other interest in the size of the estate.

Release of lien.—

Regulation. The statute provides that, if the Commissioner is satisfied that the tax liability of an estate has been fully discharged or provided for, he may issue his certificate releasing any or all property of the estate from the lien. The issuance of certificates is a matter resting within the discretion of the Commissioner, and certificates will be issued only in case there is actual need therefor. In most cases the receipts issued by the collector constitute sufficient acquittance.

The tax will be considered fully discharged for the purpose of the issuance of a certificate only when investigation has been completed, and payment of the tax, as determined by the Commissioner, has been made. A certificate of release of lien may be issued by the Commissioner under these circumstances as to any or all property of the estate, upon the filing by the executor of an application in duplicate on Form 791. The form must contain all the information called for.

Where the tax liability has not been fully discharged, as provided above, no general certificate of release will be granted, but releases of lien upon particular items of property will be issued upon the filing with the Commissioner of such security, if any, as he may require. Where security is required, a corporate indemnity bond must be furnished, or Liberty Bonds, or other bonds or notes of the United States, must be deposited with the collector. In lieu of such security, the Commissioner may in any case issue the release upon payment of the estimated tax upon the transfer of the property released, computed at the highest rate applicable to the estate. If, upon consideration of the application, the Commissioner finds the issuance of the certificate to be warranted, the collector will notify the executor of the amount of the bond, as fixed by the Commissioner. (Reg. 63, Art. 87.)

Penalties

There is only one penalty section under this title, making specific allusion to the sections dealing with the estate tax. The general provisions of the Revised Statutes regarding penalties, claims for abatement or refund, and other administrative questions are the same as apply to the other titles of the 1921 law. These are dealt with in detail in the respective chapters of this book.

LAW. Section 410. That whoever knowingly makes any false statement in any notice or return required to be filed under this title shall be liable to a penalty of not exceeding $5,000, or imprisonment not exceeding one year, or both.

Whoever fails to comply with any duty imposed upon him by section 404, or, having in his possession or control any record, file, or paper, containing or supposed to contain any information concerning the estate of the decedent, or, having in his possession or control any property comprised in the gross estate of the decedent, fails to exhibit the same upon request to the Commissioner or any collector or law officer of the United States, or his duly authorized deputy or agent, who desires to examine the same in the performance of his duties under this title, shall be liable to a penalty of not exceeding $500, to be recovered, with costs of suit, in a civil action in the name of the United States.[64]

Classification of penalties.—

REGULATION. Two kinds of penalties are provided for delinquency with respect to the duties imposed by the estate tax law:

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[64] See also section 1311, pages 147-152.

(1) A specific penalty, to be recovered by suit, unless paid on demand or adjusted by an acceptance of an offer in compromise; and

(2) A penalty of a certain percentage of the tax, to be added to the tax and collected in the same manner as the tax.

In any case where more than one penalty is provided, the Government may impose any one or more thereof. (Reg. 63, Art. 88.)

False and fraudulent notice or return.—

Regulation. Where statements in the notice required by Section 404, or in the return, are knowingly and willfully false, the person making them is subject to a penalty not exceeding $5,000, or imprisonment for not exceeding one year, or both; and, for a false or fraudulent return, 50 per centum may be added to the amount of the tax. (Reg. 63, Art. 89.)

Failure to file notice or return.—

Regulation. For failure to file the notice or the return within the time prescribed, the person in default is subject to a penalty not to exceed $500; and, for the failure to file the return within the time prescribed, 25 per centum may be added to the amount of the tax, unless the failure so to file the return was due to a reasonable cause, and not to willful neglect. (Reg. 63, Art. 90.)

Failure to exhibit records or property.—

Regulation. Where a person in possession or control of any record, file, or paper, supposed to contain information relating to the estate, or having in his possession or control property comprised in the gross estate of the decedent, fails to exhibit the same, upon the request of the Commissioner or any collector or law officer of the United States, or his duly authorized deputy or agent, in the performance of his duties, he is liable to a penalty not to exceed $500, to be recovered by civil action. He must comply with such a request whether or not he believes that the documents contain information relating to the estate. (Reg. 63, Art. 91.)

Claims for Abatement and Refund

Regulation. Two forms of relief are afforded the executor in cases where he believes that an excessive amount of tax or an illegal penalty has been assessed or paid either upon the basis of the return or of the investigation conducted by the Bureau. The two forms of relief are:

(1) Claim for abatement, where the alleged excessive tax or illegal penalty has been assessed but not paid.

(2) Claim for refund, where such tax or penalty has been paid. (Reg. 63, Art. 92.)

Claim for abatement.—

Regulation. Claims for the abatement of taxes or penalties illegally assessed must be made upon Form 843, and must be sustained by the affidavit of the executor or other parties cognizant of the facts. When a tax or penalty has been assessed, the presumption is that the assessment is correct; and the burden of showing that it was improperly or illegally assessed rests upon the applicant for abatement. The affidavit must therefore contain a full and explicit statement of all the material facts relating to the claim in support of which it is offered in order that the claim may receive proper consideration. Nothing should be left to inference, but all the facts relied upon should appear in the papers themselves. The filing of a claim for the abatement of a tax or penalty alleged to have been erroneously or illegally assessed does not necessarily operate as a suspension of the collection thereof. The collector may proceed to collect if he thinks it necessary, and leave the taxpayer to his remedy by a claim for refund. (Reg. 63, Art. 93.)

Accrual of interest as affected by abatement claim.—

Regulation. Where a claim for abatement is rejected, the making of the application does not affect the running of interest. The allowance of the claim, however, in whole or part, discharges all liability for interest upon the portion of the claim allowed. The same rules apply where, upon the request of the executor, a reinvestigation is made. (Reg. 63, Art. 94.)

Limitation of time to file claim for abatement of excess tax.—

Regulation. If it is desired to file claim for abatement of the additional amount of tax disclosed upon an investigation, such claim must be filed with the collector within one month after receipt by the executor of the Commissioner's letter of notification. After that period the claim will not be considered, but the tax must be paid, and adjustment sought by claim for refund. (Reg. 63, Art. 95.)

Claim for refund.—

Regulation. Claims for the refunding of estate taxes imposed by any of the several Revenue Acts, and of penalties in respect thereto, which are alleged to have been collected without legal authority, must be presented to the Commissioner within four years next after payment thereof. Such claims must be made on Form 843. As in the case of claims for abatement, the burden of proof rests upon the claimant. All the facts relied upon in support of the claim

should be clearly set forth under oath. With the claim should be presented, in addition to the evidence:

(1) Where the claim is made by an executor or administrator, a certificate of the court showing that the appointment remains in full force and effect.

(2) Where the executor or administrator has been discharged and no administrator de bonis non has been appointed and qualified, there should be submitted, in lieu of the certificate above mentioned, (a) a certified copy of the court order granting the discharge, and, (b) a certified copy of the order of distribution, or, if such order does not fully disclose the identity of the person or persons entitled to receive any amount that may be refunded and the percentage or proportion thereof to which each, if more than one, is entitled, there should be submitted a certified copy of the decedent's will, if any, and such further proof as may be requisite to establish both the identity of such person or persons and the percentage or proportion of the amount sought to be refunded to which each, where there are more than one, is entitled.

(3) Where a claim is filed after the administration of the estate has been closed, and is signed by one only, or by less than all, of a number of beneficiaries entitled to share in the refund, or is signed by a person acting as attorney or agent for the interested parties, there must accompany the claim, in addition to the proof required in paragraph (2) above, a power of attorney, duly executed by all beneficiaries entitled to any portion of the repayment, authorizing the claimant or claimants to present the matter before the Bureau. (Reg. 63, Art. 96.)

Payment of claims and interest.—

Regulation. Warrants in payment of claims allowed will be drawn to the order of the person or persons entitled to the proceeds, and will be forwarded directly to such person or persons by the Treasurer of the United States, except where delivery to an attorney or agent has been authorized in accordance with the regulations contained in Treasury Department Circular No. 230, dated April 25, 1922, as heretofore or hereafter amended or supplemented. If the claimants are indebted to the United States for taxes, such taxes must be paid before the warrants are delivered. (Act of March 3, 1875 (18 Stats. 481).) . . . . (Reg. 63, Art. 97.)

Refund of tax arising from change in law.—Due to the changes in the deductibility of certain items made by section 403 (a-2-3) and (b-2-3), a refund of tax is possible in certain cases.

LAW. Section 403. (b) (3) . . . . In the case of any estate in respect to which the tax has been paid, if necessary to allow the benefit of the deduction under paragraphs (2) and (3) of subdivision (a) or (b) the tax shall be redetermined and any excess of tax paid shall be refunded to the executor.

The paragraphs referred to in the foregoing have reference to the deductibility from the value of the gross estate in the case of both residents and non-residents, of (1) the value of property forming part of the gross estate of any person who died within five years of the decedent, and (2) the amount of bequests, legacies, devises or transfers for public, charitable, etc., uses.

The deductions may be made in the case of the estate of any decedents who have died since December 31, 1917. January 1, 1918, is the effective date of the law of 1918, which first provides for the deduction of property coming under the specific headings enumerated in section 403 of the 1921 law.

Miscellaneous Provisions

Examination of records and taking of testimony.—

LAW. Section 1308. That the Commissioner, for the purpose of ascertaining the correctness of any return or for the purpose of making a return where none has been made, is hereby authorized, by any revenue agent or inspector designated by him for that purpose, to examine any books, papers, records, or memoranda bearing upon the matter required to be included in the return, and may require the attendance of the person rendering the return or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matter required by law to be included in such return, with power to administer oaths to such person or persons.

Section 1310. (a) That if any person is summoned under this Act to appear, to testify, or to produce books, papers or other data, the district court of the United States for the district in which such person resides shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

(b) The district courts of the United States at the instance of the United States are hereby invested with such jurisdiction to make and issue, both in actions at law and suits in equity, writs and orders of injunction, and of ne exeat republica, orders appointing receivers, and

such other orders and process, and to render such judgments and decrees, granting in proper cases both legal and equitable relief together, as may be necessary or appropriate for the enforcement of the provisions of this Act. The remedies hereby provided are in addition to and not exclusive of any and all other remedies of the United States in such courts or otherwise to enforce such provisions. . . . .

REGULATIONS. In order to ascertain the correctness of a return, or to make a return where none has been made, the Commissioner has power to require the attendance, and to take the testimony, of the person rendering the return, or any officer or employee of such person, or any other person having knowledge in the premises. Such persons may be required to produce any relevant book, paper, or other record. This power may be exercised by any revenue agent or inspector designated for the purpose. (Reg. 63, Art. 100.)

Where any person is summoned to appear and testify, or to produce books, papers, or other data, the District Court of the United States for the district in which such person resides has power to compel the giving of the testimony, or the production of the books, papers, or data, and to issue any appropriate process, writ, or order. (Reg. 63, Art. 101.)

Executor's duty to keep records.—

REGULATION. It is the duty of the executor to keep such records as the Commissioner may require. Executors are required to keep such complete and detailed records of the affairs of the estate, as will enable the Commissioner to determine accurately the amount of the tax liability. (Reg. 63, Art. 103.)

Executor's duty to render statements.—

REGULATION. It is also the duty of the executor not only to make the formal return, but also to render any other sworn statement which the Commissioner may require for the purpose of determining whether a tax liability exists. (Reg. 63, Art. 104.)

Proceedings in United States Court for China.—

LAW. Section 411. (a) That the term "resident" as used in this title includes a citizen of the United States with respect to whose property any probate or administration proceedings are had in the United States Court for China. Where no part of the gross estate of such decedent is situated in the United States at the time of his death, the total amount of tax due under this title shall be paid to or collected by the clerk of such court, but where any part of the gross estate of such decedent is situated in the United States at the time of his death, the tax due under this title shall be paid to or collected by

the collector of the district in which is situated the part of the gross estate in the United States, or, if such part is situated in more than one district, then the collector of such district as may be designated by the Commissioner.

(b) For the purpose of this section the clerk of the United States Court for China shall be a collector for the territorial jurisdiction of such court, and taxes shall be collected by and paid to him in the same manner and subject to the same provisions of law, including penalties, as the taxes collected by and paid to a collector in the United States.

(c) The proviso in the Act entitled, "An Act making appropriation for the Diplomatic and Consular Service for the fiscal year ending June 30, 1921," approved June 4, 1920, which reads as follows: *"Provided,* That in probate and administration proceedings there shall be collected by said clerk, before entering the order of final distribution, to be paid into the Treasury of the United States, the same inheritance taxes from time to time collected under the laws enacted by the Congress of the United States from the estates of decedents residing within the territorial jurisdiction of the United States," is hereby repealed.

Apart from the particular application of the term "resident" indicated by the above section, there is the ordinary meaning of the term as generally used in the law. The question of citizenship does not enter into the matter at all; the two types of taxpayers involved being resident and non-resident.

The particular definition included in section 411 having regard to *citizens* of the United States coming under the jurisdiction of the extra-territorial court in China, is necessary in order to carry out the provision of the act alluded to in (c) of that section.

Scope of repeal.—

LAW. Section 1400. (a) That the following parts of the Revenue Act of 1918 are repealed . . . . to take effect . . . .

Title IV (called "Estate Tax"); on the passage of this act. . . . .

(b) The parts of the Revenue Act of 1918 which are repealed by this Act shall (unless otherwise specifically provided in this Act) remain in force for the assessment and collection of all taxes which have accrued under the Revenue Act of 1918 at the time such parts cease to be in effect, and for the imposition and collection of all penalties or forfeitures which have accrued or may accrue in relation to any such taxes. In the case of any tax imposed by any part of the Rev-

enue Act of 1918 repealed by this Act, if there is a tax imposed by this Act in lieu thereof, the provision imposing such tax shall remain in force until the corresponding tax under this Act takes effect under the provisions of this Act. The unexpended balance of any appropriation heretofore made and now available for the administration of any such part of the Revenue Act of 1918 shall be available for the administration of this Act or the corresponding provision thereof.

Non-Resident Estates

Resident and non-resident estates are in general treated in a similar manner for the purpose of the estate tax. There are, however, certain particular differences in the treatment of non-resident estates which are discussed in the following.

Method of determination of net estate of non-residents.—In computing the net estate of a non-resident which is subject to tax, there are two important differences from the procedure in the case of resident estates:

1. There is no specific exemption of $50,000.
2. Only the amount of the gross estate which is deemed to be situated in the United States is considered, and from this amount the statutory deductions (limited to 10 per cent of the gross estate[65]) are subtracted.

Situs of certain property of non-resident estates.—

Law. Section 403. . . . . (b) . . . . (3) . . . . For the purpose of this title stock in a domestic corporation owned and held by a nonresident decedent shall be deemed property within the United States, and any property of which the decedent has made a transfer or with respect to which he has created a trust, within the meaning of subdivision (c) of section 402,[66] shall be deemed to be situated in the United States, if so situated either at the time of the transfer or the creation of the trust, or at the time of the decedent's death.

The amount receivable as insurance upon the life of a nonresident decedent, and any moneys deposited with any person carrying on the banking business, by or for a nonresident decedent who was not en-

[65] Section 403 (b-1).
[66] A trust created in contemplation of death.

gaged in business in the United States at the time of his death, shall not, for the purpose of this title, be deemed property within the United States. . . . .

Regulation. Bonds actually within the United States, moneys due on open accounts by domestic debtors, and stock of a corporation or association created or organized in the United States, constitute property having its situs in United States. On the other hand, insurance upon the life of a nonresident, and moneys deposited with any person or corporation carrying on the banking business in the United States by or for a nonresident not engaged in business in the United States at the time of his death, are not to be regarded as property situated therein.

Property of which the decedent has made a transfer, or with respect to which he has created a trust, in contemplation of, or intended to take effect in possession or enjoyment at or after, death, is deemed to be situated in the United States if so situated either at the time of the transfer or the creation of the trust, or at the time of the decedent's death. (Reg. 63, Art. 53.)

The exclusion of the proceeds of life insurance, or bank deposits, is an exemption granted to non-residents for the first time in this law. Heretofore, when the insurer was a domestic corporation, insurance receivable from such a source was deemed to be property within the United States, and, as such, subject to inclusion in the taxable gross estate. Neither of these exemptions apply to non-residents engaged in business in the United States.

Regulations. The gross estate of a resident and of a nonresident are made up in the same way. In ascertaining the net estate, however, the transfer of which is subject to tax, there is a radical difference between the two cases. The net estate in the case of a resident is determined by making specified deductions from the entire gross estate, whereas the net estate in the case of a nonresident is determined by making the deductions from the value of so much of the gross estate as is situated in the United States. Thus, in substance, the statute imposes the tax only upon the transfer of so much of the estate of a nonresident as, under the terms of the statute, had its situs in the United States. On the other hand, the estates of nonresidents are not entitled to the specific exemption of $50,000. (See Art. 58.) (Reg. 63, Art. 54.)

The following example will show the manner of determining the net estate of a nonresident decedent. The gross estate, wherever situated, amounts to $1,000,000, of which $200,000 represents the value

of the property having its situs within the United States (the term "United States" including not only the several States, but also the Territories of Alaska and Hawaii, and the District of Columbia). The funeral expenses, administration expenses, and claims against the estate aggregate $75,000, and there are charitable bequests, for use within the United States, amounting to $25,000. Hence the property situated within the United States constitutes 20 per cent of the entire gross estate wherever situated, and a like percentage of the $75,000 is $15,000. As the last named amount does not exceed 10 per cent of the value of the property situated in the United States, the whole thereof is deductible. The following result is accordingly obtained:

Gross estate within the United States		$200,000
20 per cent of $75,000	$15,000	
Charitable bequests for use within the United States	25,000	
		40,000
Net estate		160,000

For the manner of computing the tax on the net estate, see Article 8.

In the example given, had the funeral expenses, administration expenses and claims against the estate aggregated $150,000, 20 per cent thereof, or $30,000, would not have been deductible for the reason that it would have exceeded 10 per cent of the value of the property situated in the United States; such 10 per cent being the maximum permitted by the statute. The deduction would accordingly have been limited to 10 per cent of $200,000, plus the charitable bequests, or a total of $45,000, and the resultant net estate would have been $155,000, instead of the amount given in the example. (Reg. 63, Art. 58.)

It is presumed that insurance payable to individuals other than the executor in excess of $40,000 has been included in the gross estate in arriving at the $200,000.

Missionaries classed as residents.—

Law. Section 403. . . . . (b) . . . . (3) . . . . **Missionaries duly commissioned and serving under boards of foreign missions of the various religious denominations in the United States, dying while in a foreign missionary service of such boards, shall not, by reason merely of their intention to permanently remain in such foreign service, be deemed nonresidents of the United States, but shall be presumed to be residents of the State, the District of Columbia, or the Territories of Alaska or Hawaii wherein they respectively resided at the time of their commission and their departure for such foreign service. . . .**

The foregoing paragraph applying to missionaries and, in effect, placing them in the same plane as residents, so far as deductions and exemptions are concerned, is a new and equitable feature of the 1921 law.

Deductions allowed non-resident estates.—

Law. Section 403. That for the purpose of the tax the value of the net estate shall be determined— . . . .

(b) In the case of a nonresident, by deducting from the value of that part of his gross estate which at the time of his death is situated in the United States—

(1) That proportion of the deductions specified in paragraph (1) of subdivision (a) of this section[67] which the value of such part bears to the value of his entire gross estate, wherever situated, but in no case shall the amount so deducted exceed 10 per centum of the value of that part of his gross estate which at the time of his death is situated in the United States;

(2) An amount equal to the value of any property forming a part of the gross estate situated in the United States of any person who died within five years prior to the death of the decedent where such property can be identified as having been received by the decedent from such prior decedent by gift, bequest, devise, or inheritance, or which can be identified as having been acquired in exchange for property so received: *Provided,* That this deduction shall be allowed only where an estate tax under this or any prior Act of Congress was paid by or on behalf of the estate of such prior decedent, and only in the amount of the value placed by the Commissioner on such property in determining the value of the gross estate of such prior decedent, and only to the extent that the value of such property is included in that part of the decedent's gross estate which at the time of his death is situated in the United States and not deducted under paragraphs (1) or (3) of subdivision (b) of this section. This deduction shall be made in case of the estates of all decedents who have died since September 8, 1916,[68] and

(3) The amount of all bequests, legacies, devises, or transfers, except bona fide sales for a fair consideration, in money or money's worth, in contemplation of or intended to take effect in possession or enjoyment at or after the decedent's death, to or for the use of the United States, any State, Territory, any political subdivision thereof, or the District of Columbia, for exclusively public purposes, or to or for the use of any domestic corporation organized and operated

[67] See page 1415 *et seq.*

[68] This subsection is identical with section 403 (a-2). For a full discussion, see page 1423 *et seq.*

exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, or to a trustee or trustees exclusively for such religious, charitable, scientific, literary, or educational purposes within the United States. This deduction shall be made in case of the estates of all decedents who have died since December 31, 1917.

No deduction shall be allowed in the case of a nonresident unless the executor includes in the return required to be filed under section 404 the value at the time of his death of that part of the gross estate of the nonresident not situated in the United States. . . .

Except for the 10 per cent limitation included in paragraph (1) above, the section quoted provides the same general deductions for non-residents as in the case of resident estates. *The specific exemption of $50,000 does not, however, apply as far as non-resident estates are concerned.*

Deduction for claims and expenses of non-residents.—

Regulation. In estates of nonresidents, deduction from gross estate may be taken, subject to the limitations herein subsequently to be referred to, of disbursements for funeral expenses, administration expenses, claims against the estate, unpaid mortgages, losses incurred during the settlement of the estate arising from fires, storms, shipwreck, or other casualty, or from theft, when such losses are not compensated for by insurance or otherwise, amounts reasonably required and actually expended for the support during settlement of the estate of those dependent upon the decedent, as are allowed by the laws of the jurisdiction under which the estate is being administered. Treatment of the several deductions enumerated above will be found in Articles 32 to 43, inclusive. No deduction may be taken of any income taxes upon income received after the death of the decedent, or of any estate, succession, legacy, or inheritance taxes. It is immaterial whether the amounts to be deducted were incurred or expended within or without the United States, but certain limitations are imposed which do not apply to estates of resident decedents, namely: (1) Only that proportion of the aggregate thereof is deductible which the value of that part of the gross estate, which at the time of decedent's death was situated in the United States, bears to the value of the entire gross estate, wherever situated; and in no event may a sum be deducted in excess of 10 per centum of the value of that part of the gross estate which at the time of death was situated in the United States. (See Art. 58.) Such 10 per

centum limitation does not apply to the deductions subsequently considered in Articles 56 and 57. (2) No deduction whatever may be taken unless the executor includes in the return the value at the date of the nonresident's death of that part of the gross estate not situated in the United States.

In order that the Commissioner may properly pass upon the items claimed as deductions, the executor should submit a certified copy of the schedule of liabilities, claims against the estate and expenses of administration filed under the foreign estate, succession, or death-duty act; or, if no such schedule was filed, a certified copy of the schedule of such liabilities, claims and expenses filed with the foreign court in which administration was had; or, if items of deduction allowable under section 403 (b) (1) were not included in either such schedule, or, if no such schedules were filed, then the affidavit of the foreign executor setting forth the facts relied upon as entitling the estate to the benefit of the particular deduction or deductions. (Reg. 63, Art. 55.)

Deduction for property previously taxed.—

Regulation. The right to deduct the value of property received by a nonresident decedent from any person dying within five years prior to his death, or of the value of property acquired in exchange for property so received, is governed by the same rules as those which apply to estates of resident decedents, subject to the two following exceptions: (1) That such right is limited to the extent that the value of the property, or of that acquired in exchange therefor, is not deducted under paragraphs (1) or (3) of subdivision (b) of Section 403; (2) That such right is not available to any extent unless the executor includes in the return the value at the time of the decedent's death of that part of the gross estate not situated in the United States. (See Arts. 44 to 46, inclusive.) (Reg. 63, Art. 56.)

Deductions for public, charitable, or similar gifts by non-residents.—

Regulation. The right to deduct the value of property transferred by nonresidents for public, religious, charitable, scientific, literary, or educational purposes is governed by the same rules as those applying to estates of resident decedents (Arts. 47 to 51, inclusive), subject, however, to the two following exceptions, namely: (1) That the right is limited to transfers to corporations and associations created or organized in the United States, or to trustees for use within the United States, and, (2) is then available only where the executor includes in the return the value at the time of the non-

resident decedent's death of that part of the gross estate not situated in the United States. (Reg. 63, Art. 57.)

Two months' notice—non-resident estates.—

REGULATION. In estates of nonresidents, notice on Form 705 should be filed with the Commissioner of Internal Revenue, Washington, D. C., by every duly qualified executor or administrator. The notice is necessary if any part of the decedent's gross estate was situated in the United States at the time of death, regardless of the value of that part or of the entire gross estate. If no executor or administrator has been appointed, notice must be filed within two months after the date of death by every person in either the actual or constructive possession of any property of the decedent within the United States at the time of his death. If such person has no knowledge of the decedent's death within two months following its occurrence, he should file the notice immediately upon obtaining such knowledge. If there is a delay of more than two months after the death in the appointment of an executor or administrator, persons so in possession should file notice. The term "person in actual or constructive possession of any property of the decedent" (Section 400) includes, among others, the decedent's agents and representatives; safe-deposit companies, warehouse companies, and similar custodians of property in this country of a nonresident decedent; brokers holding as collateral securities belonging to the decedent or investment funds owned by the decedent, and debtors of the decedent in this country, but does not include any person, corporation, or association carrying on the banking business with whom or with which money was deposited by or for the decedent, unless, however, the decedent was engaged in business in the United States at the time of his death. (Reg. 63, Art. 64.)

TRANSFER AGENTS' TWO MONTHS' NOTICE.—

REGULATION. A notice on Form 714 is required to be filed whenever a corporation, its transfer agent, registrar, or paying agent, is called upon to make a transfer of stock or bonds, or to pay dividends or interest, to any successor in interest of a nonresident stockholder or bondholder who died after September 8, 1916, unless the transfer is made upon the order of an executor or administrator appointed in the United States. The notice is required for dividends declared, and for interest which had accrued on bonds, prior to the death of the decedent, although payable thereafter. Notice should be filed with the Commissioner of Internal Revenue at Washington, D. C., within two months following the date of death, or immediately upon receipt of the request for transfer or payment. A transfer agent should be vigilant to report all cases in which the fact of the death

of a nonresident appears. Where the securities are received without the personal assignment of the decedent, but with the transfer order of the foreign executor, it is clear that the case should be reported.

Where the securities bear the personal assignment of the decedent, the transfer should be reported if made upon the order of a foreign executor, or if information is received in any other manner that the record owner has died a nonresident of the United States.

In order to prevent loss of the tax upon nonresident estates, it is essential that transfer agents exercise great care in reporting all transfers of the kind described. Their records will be examined from time to time by internal-revenue officers to determine whether this regulation is being strictly complied with. Failure to file notice in the manner prescribed will render the transfer agent liable to a fine. (Reg. 63, Art. 65.)

Transfer of stocks or bonds of non-resident decedent, how made.—

Regulation. Wherever a transfer agent is required to file the notice as provided in Article 65, he shall not make transfer of any stocks or bonds standing in the name of a nonresident decedent until there has been delivered to such collector of internal revenue as may be designated by the Commissioner the bond of the party to whom the stocks or bonds are to be transferred with corporate surety in an amount to be fixed by the Commissioner, not exceeding in amount the value of the stocks or bonds to be transferred, conditioned for the payment of the tax upon the transfer of the decedent's net estate. Upon receipt of such notice the Commissioner will at once, upon request, fix the amount for which the bond is to be given. In lieu of such bond a deposit, either of money or of bonds of the United States, of the amount so fixed may be made with such collector of internal revenue as the Commissioner may designate.

Where bonds of the United States or moneys are deposited in lieu of the delivery of such corporate bond, return will be made thereof to the depositor after payment in full of the tax on the transfer of the decedent's net estate. If, however, the tax be not paid in full on or before the due date thereof, or within such period as payment may have been extended by the Commissioner, the collateral will be subjected to payment of the tax, or the then unpaid balance thereof, and the excess of the deposit, or of the proceeds thereof remaining, if any, will be returned to the depositor. In lieu of the provisions and restrictions hereinbefore set forth, transfer agents are authorized to make transfer of stocks and bonds standing in the name of a nonresident decedent to the duly qualified ancillary executor or administrator within the United States, provided that such transfer agent at the time of making such transfer gives notice thereof in writing to the Commissioner of Internal Revenue. (Reg. 63, Art. 66).

Returns for non-resident estates.—

DATE OF FILING RETURNS—WHO SHALL MAKE RETURNS.—

REGULATION. A return on Form 706 must be filed in duplicate with the Commissioner of Internal Revenue, Washington, D. C., or with such collector of internal revenue as the Commissioner may designate, within one year after the date of death of every non-resident decedent, if any part of the gross estate of such decedent was situated in the United States at the time of his death. It is the duty of the duly qualified executor or administrator to file a return for the whole of that part of the gross estate situated in the United States, whatever its value. If the duly qualified executor or administrator is unable to make a complete return as to any part of the gross estate, he is required to give all the information available to him as to such part, including a description thereof and the name of every person holding a legal or beneficial interest therein. If deductions are claimed, see Article 55, 56 and 57. If no executor or administrator has been appointed, all persons in actual or constructive possession of any property of the decedent situated in the United States are required to file a return for such portion of the gross estate as had its situs therein. (See Art. 53.) (Reg. 63, Art. 73.)

Supplemental data.—

REGULATION. Pursuant to the provisions of Section 404, with respect to furnishing supplemental data, the duly qualified executor or administrator of a nonresident decedent is required to file with the return:

(1) Certified copy of will, or, if the decedent left several wills, to govern in different jurisdictions, certified copy of each will.

(2) Certified copy of inventory of property filed under a foreign estate, succession, or death-duty act; or, if no such inventory was filed, a certified copy of inventory filed with the foreign court of probate jurisdiction. . . . . (Reg. 63, Art. 74.)

CHAPTER XLVI

FEDERAL CAPITAL STOCK (EXCISE) TAX

As a means of raising additional revenue, Congress in 1916 imposed an excise tax, effective January 1, 1917,[1] on corporations for the privilege of doing business. Since that date many unsuccessful attempts have been made to repeal or change the law.[2] The net result of the changes from 1916 to January 1, 1923, has been an increase in the rate and a reduction in the exemption. The 1921 law (which, as to the capital stock section[3] did not become effective until July 1, 1922) re-enacted the tax in substantially the same form as it appeared in the 1918 law, the principal change being that insurance companies subject to tax imposed by section 243 or section 246 of the 1921 law are exempt from the capital stock tax.[4]

The rate now in force for domestic corporations is $1[5] for each full $1,000 of the average fair value of the capital stock for the year preceding the taxable year in excess of the exemption of $5,000.[6] The rate is comparatively low and the exemption such that the total tax is not excessive.

In his report for 1919 the Commissioner stated: "The early regulations touching valuations have been radically elab-

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[1] Title IV of the Revenue Act of September 8, 1916 (Public No. 271, 64th Congress).

[2] In considering the Revenue Act of 1921 the Senate Finance Committee proposed omitting the tax.

[3] Section 1000.

[4] **[Former Procedure]** Section 1000 (c) of 1918 law read "The taxes imposed by this section shall apply to mutual insurance companies." Stock companies were taxable as ordinary corporations (Reg. 50, Art. 22). Organizations doing business on reciprocal or inter-indemnity plan were subject to tax. (C. B. 4, page 272; L. O. 1063.)

[5] **[Former Procedure]** The rate under the 1916 law was 50 cents for each $1,000, and the exemption was $99,000. The rate was increased to $1 and the exemption reduced to $5,000 by the 1918 law. The provisions of the 1918 law (passed February 24, 1919) were made retroactive to July 1, 1918.

[6] Foreign corporations, however, are not permitted any exemption.

orated and modified until under present approved methods it has become necessary to individualize each case, considering all elements and factors which throw light on values and harmonizing them so far as possible in the ultimate values found."

This amounts to an admission that the earlier regulations were wrong. The early administration of the law did not reflect credit on the Treasury. Originally an attempt was made to divide corporations into a few classes and value the capital stock of all the companies in each class on practically the same basis. During recent years, however, there has been a continuous improvement in administration.

The Commissioner in his report for the fiscal year ended June 30, 1922, states that:

> The additional capital stock assessed and collected as a result of the audit for the fiscal year ended June 30, 1922 was $9,258,697.72 compared with $7,761,988.85 for the fiscal year 1921. . . . . The capital stock tax has been in effect since January, 1917 with only slight modifications in the law and is an important revenue producer at small cost.

While it is true that the cost of collection appears to be relatively slight, such slight cost may be ascribed to the fact that the additional assessments are in most cases relatively so small that taxpayers are inclined to pay rather than engage in protracted correspondence or litigation with the Capital Stock Tax Division of the Bureau of Internal Revenue. In other words, the low cost of collecting additional taxes is due to the fact that taxpayers are not disposed to litigate comparatively small overassessments.

Theoretically, the tax is on the privilege of doing business in a corporate capacity, but it is difficult to assess a tax on the "fair" value of capital stock without considering past earnings, so that in many cases the tax amounts to an additional income tax.

All the corporations (educational, fraternal, etc.) exempt under the income tax law are also exempt from this tax. In

addition, many corporations organized for profit but not "doing business," as interpreted by the Supreme Court of the United States, are also exempt. This applies to lessor, inactive and similar corporations.

The tax is payable in advance and the next return will be due in July, 1923. The law [section 1000 (a-1)] provides that the computation of the tax of a domestic corporation shall be based on "the fair average value of its capital stock for the preceding year." Therefore, the return due on or before July 31, 1923, will be based on the average value, etc., during the year July 1, 1922 to June 30, 1923—the government's fiscal year.[7]

The Treasury has issued regulations[8] which are reproduced in the following pages, governing the preparation of returns, etc. The law is wisely silent as to many details which usually encumber tax bills.

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[7] [Former Procedure] The following provision was made on form 707 (prior to revision) for a corporation's fiscal year which ended at some date other than June 30: "In item 7 on page 1 hereof the taxpayer will show the closing date of its fiscal year ended between July 1, 1921, and June 30, 1922, if other than June 30, and the information furnished under exhibits A, B and C will be as of the year or years ended on such date, which should be used annually." In form 707 issued for the 1923 returns, the taxpayer is requested to "Furnish under Exhibit A a condensed balance sheet as of June 30, 1922, if possible, but in no case earlier than December 31, 1921."

[8] [Former Procedure] Regulations 38 were issued October 19, 1916. Regulations 38 (revised) were issued August 9, 1918. Regulations 50 were issued April 29, 1919. Regulations 50 (revised) were issued June 21, 1920. Regulations 64, now in force, were issued June 15, 1922. In the opinion of the author the requirements of the 1916 regulations were reasonable, but T. D. 2503 (June 25, 1917) imposed new methods of ascertaining the "fair value" of the corporate stock which were fallacious, not in accord with the law and unenforceable.

As the valuation of capital stock is the basis for the assessment of the tax, the importance of a correct formula for calculating "fair value" should not be underestimated. Detailed criticism of the regulations will be found in *Income Tax Procedure*, 1918, pages 628 to 677.

Regulations 38 (revised, 1918) and Regulations 50 (April, 1919) did not continue the former objectionable instructions. Therefore, it is considered unnecessary to repeat in this book most of the comments on the original regulations.

From information which has come to the author it seems that very many close corporations were over-assessed, but that practically no corporation whose stock was listed on an exchange was so treated. The corporations which were over-assessed should apply for a refund.

Domestic Corporations

Effective date.[9]—

Regulation. . . . . This is a special tax and like all special taxes is due and payable annually in advance from July 1 of each year. No portion of the tax so paid is refundable to a corporation which ceases to do business during the year. (Reg. 64, Art. 2.)

The foregoing regulation is based on section 3237, Revised Statutes,[10] which applies to the assessment of special taxes. As to corporations organized and beginning corporate activities after July 1 in any year, however, section 3237 is superseded by the act imposing the federal capital stock tax. Section 1000 (b) of the law, quoted on page 1477, specially provides that the tax "shall not apply in any year to any corporation which was not engaged in business . . . . during the preceding year ending June 30." This limitation is recognized in article 28 of Regulations 64, which will be found on pages 1477-8.

Scope of tax.—

Law. Section 1000. **(a) . . . . (1) Every domestic corporation**[11]. . . .

Definition of domestic corporations.—

Regulations. A domestic corporation is a corporation created or organized in the United States, which includes the States, Territories of Alaska and Hawaii, and the District of Columbia. (Reg. 64, Art. 9.)

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[9] [Former Procedure] A business enterprise, which qualified under section 229 and elected to be taxed as a corporation, was required to file a capital stock tax return and pay the tax for the six months' period, January 1 to June 30, 1921, and the twelve months' period, July 1, 1921, to June 30, 1922.

[10] Law. All special taxes shall become due on the 1st day of July, 1891, and on the 1st day of July in each year thereafter, or on commencing any trade or business on which such tax is imposed. In the former case the tax shall be reckoned for one year, and in the latter case it shall be reckoned proportionately from the 1st day of the month in which the liability to a special tax commenced to the 1st day of July following. [Section 3237, Revised Statutes, as amended by section 53 of the act of October 1, 1890 (26 Stats., 567).]

[11] Certain corporations are specifically exempted from the tax by the statute. See page 1477.

The term "corporation" includes associations and joint-stock companies, whether created by statute or by contract,[12] but no partnerships, properly so called. It is immaterial whether the companies were organized for profit or have a capital stock represented by shares. (Reg. 64, Art. 3.)

PERSONAL SERVICE CORPORATIONS.[13]—

REGULATION. . . . . Personal service corporations so classified under the Revenue Act of 1918 are exempt from capital-stock tax for the taxable period July 1, 1921, to June 30, 1922, but are liable to capital-stock tax the same as other corporations effective July 1, 1922, under the Revenue Act of 1921. (Reg. 64, Art. 29.)[14]

ASSOCIATIONS AND LIMITED PARTNERSHIPS WHICH ARE INCLUDED.—

REGULATIONS. Associations and joint-stock companies include organizations, by whatever name known,[15] which act or do business

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[12] **[Former Procedure]** The 1918 law specifically included insurance companies in the scope of the tax.

[13] **[Former Procedure]** Under the 1918 law [section 231 (14)] personal service corporations were exempt because they were taxed as partnerships.

To be exempt from the capital stock tax under the 1918 law, personal service corporations were required to be granted full classification as such by the Income Tax Unit for the purpose of the income and profits taxes.

Art. 28, Reg. 50 (revised), required that returns be filed and fair value of capital stock shown. Tax was not to be computed, however, and in lieu thereof the words "exemption claimed" inserted. A full statement of the reasons for claiming exemption was required to be attached to the return.

REGULATION. . . . . To be exempt from capital stock tax corporations must have previously been granted full classification as personal service corporations for the purpose of Federal income and profits taxes under Regulations 45, revised. . . . . (Reg. 50, revised, Art. 27.)

[14] The Treasury held for some time that personal service corporations were liable to the tax commencing January 1, 1922.

RULING. There is no provision . . . . which relieved personal service corporations from . . . . filing . . . . for the six-months' period, January 1 to June 30, 1922. (L. S. Ruddick, Acting Deputy Commissioner to Kix Miller & Baar, December 15, 1921.)

In *Income Tax Procedure*, 1922, the author stated as his opinion that there was no provision in the 1921 law for taxing personal service corporations for the first six months of 1922. (See *Income Tax Procedure*, 1922, pages 1521-31.) Article 29 of Regulations 64 reverses the ruling by the Acting Deputy Commissioner and confirms the author's position.

[15] "Massachusetts trusts" were held to be exempt from the excise tax in *Eliot v. Freeman, et al.* [220 U. S. 178, 55 L. Ed. 424, 31 Sup. Ct.

in an organized capacity, whether created under and pursuant to State laws, agreements, declarations of trust, or otherwise, the net income of which, if any, is distributable among the members or shareholders on the basis of the capital stock held by each, or, where there is no capital stock, on the basis of the proportionate share of capital which each has or has invested in the business or property of the organization. . . . . An organization, the membership interests in which are transferable without the consent of all of the members, however the transfer may be otherwise restricted, and the business of which is conducted by trustees or directors and officers without the active participation of all the members as such, is an association. (Reg. 64, Art. 4.)

The test of liability in all cases involving trusts of the Massachusetts type is whether the cestuis que trustent have by the terms of the trust agreement a voice in the management or control of the trust. Where the trustees are in complete control of the business, the beneficiaries having no control except the right of filling vacancies among the trustees or of consenting to a modification of the terms of the trust or of dissolving the trust, no association exists. If, however, the cestuis que trustent have a voice in the control or management of the business of the trust, whether through the right to elect trustees periodically or to remove the trustees or to restrict the trustees as to the management of the trust or otherwise, the trust is an association within the meaning of the statute. Where the trustees hold in their own right a sufficient number of the certificates of beneficial interest to constitute control as between the beneficiaries, the trust will be held to be an association regardless of the powers conferred upon the trustee by the instrument creating the trust. (Reg. 64, Art. 8.)

In *Malley v. Howard et al.*,[16] it was held that certain Massachusetts trusts were subject to capital stock taxes as non-statutory associations.

Regulations. A partnership bank, conducted like a corporation and so organized that the interests of its members may be transferred without the consent of the other members, is a joint-stock company or association within the meaning of the statute. A partnership bank, the interests of whose members can not be so transferred, is a partnership. (Reg. 64, Art. 7.)

360, (T. D. 1686)], and corporations in hands of a receiver are exempt. (T. D. 2424.) In *Crocker v. Malley* (249 U. S. 223, 63 L. Ed. 573, 39 Sup. Ct. 270, 2 A. L. R. 1601) certain types of Massachusetts trusts were held not to be "associations" of the corporate type. See footnotes 8 and 9, pages 1275-6 of Chapter XLII.

[16] 281 Fed. 363, June 6, 1922. See footnotes 8 and 9, pages 1275-6 of Chapter XLII, for a discussion of these cases.

Partnerships with limited liability or partnership associations authorized by the statutes of Pennsylvania and a few other States are only nominally partnerships. Such so-called limited partnerships, offering opportunity for limiting the liability of all the members, providing for the transferability of partnership shares, and capable of holding real estate and bringing suit in the common name, are more truly corporations than partnerships, and are taxable as corporations. In all doubtful cases limited partnerships will be treated as corporations unless they submit satisfactory proof that they are not in effect so organized. Michigan partnership associations are corporations. The liability of Virginia limited partnerships is determined in each case from a consideration of the certificate of partnership and all pertinent facts relative thereto. (Reg. 64, Art. 5.)

Article 1506 of Regulations 45, issued in regard to income and profits taxes, originally provided that "Michigan and Virginia partnership associations are corporations"; but this article was amended by T. D. 2943 (November 6, 1919) to exclude Virginia partnership associations. See further, articles 1505 and 1506 of Regulations 62, pages 37, 38.

Limited partnerships which are not included.—

Regulation. So-called limited partnerships of the type authorized by the statutes of New York and most of the States are partnerships and not corporations within the meaning of the statute. Such limited partnerships which can not limit the liability of the general partners, although the special partners enjoy limited liability so long as they observe the statutory conditions, which are dissolved by the death or transfer of the interest of a general partner, and which can not hold real estate or sue in the partnership name, are so like common law partnerships that they can not be differentiated therefrom for tax purposes. Michigan and Illinois limited partnerships are partnerships. California special partnerships are partnerships. (Reg. 64, Art. 6.)

Double tax on holding companies.—As the capital stock tax is an excise tax imposed on a corporation for the privilege of doing business as a corporation, it is clear that the same assets may be taxed more than once. The fair value of the stock of a holding company includes the value of the stocks of subsidiaries. And as subsidiaries often have subsidiaries of their own, the tax is multiplied.

Corporation must be "doing business" to be taxed.—

Law. Section 1000. **(a) . . . . (1) . . . . shall pay annually a special excise tax with respect to carrying on or doing business, ...**

Regulation. The basis of the tax in the case of a domestic corporation is "carrying on or doing business" in the capacity of a corporation or association.[17] The words "carrying on or doing business" must be given their ordinary and natural signification. "Business" is a very comprehensive term and embraces whatever occupies the time, attention or labor of men for the purpose of livelihood or profit. In other words, business necessarily involves the idea of gain.

The true basis of distinction is, in the first instance, between—

(*a*) A corporation organized for the purpose of doing business as above defined, and

(*b*) A corporation organized for the sole purpose of owning and holding property and distributing its avails;

and, in the second instance, between—

(*c*) A corporation of class (*a*) which is continuing the body and substance of the business for which it was organized or is still active and maintaining its organization for the purpose of continued efforts in the pursuit of profit or gain, and

(*d*) A corporation which, although included in class (*a*), has substantially retired from the business for which it was organized and has reduced its activities to the mere ownership and holding of property, distributing its avails, and doing only the acts necessary to the maintenance of its corporate existence and the private management of its purely internal affairs.

The distinction in each case must depend upon the peculiar facts in the case. Corporations of class (*a*) will be presumed to be subject to the tax unless they submit proof, satisfactory to the Commissioner, that they are not actually carrying on or doing business. If a corporation claim exemption on the ground that it belongs to class (*b*), it will be required to file an excerpt from its charter setting forth its corporate powers together with a full and comprehensive statement showing the nature of the activities in which it is and has been actually engaged. If it claim exemption on the ground that it belongs to class (*d*), it will be required to furnish a copy of any amendment of its charter, or other evidence, satisfactory to the commissioner, showing that it has reduced its activities to the mere own-

[17] Insurance companies subject to the income tax imposed by section 243 or 246 of the 1921 law are now exempt from capital stock tax. They were taxable under the 1918 law. Certain other insurance companies, described in section 231 (10), are also exempt.

ership of property, receipt of its avails, and the doing of only what is necessary to the maintenance of its corporate existence.

A corporation that has "substantially retired from business" is one that has changed its status, as, for instance, by divesting itself of all control over and management of the property formerly employed by it in the doing of business, and has reduced its activities, accordingly.

The leasing of all the property of a corporation whereby it divests itself of control and management thereof, or the sale of all the property of a corporation and the reduction of its activities to the collection of the proceeds of the sale on an installment plan, are instances of a corporation substantially retiring from business.[18] (Reg. 64, Art. 11.)

"DOING BUSINESS" ILLUSTRATED.—

REGULATION.[19] Corporations organized for the purpose of and actually engaged in such activities as buying, selling, or dealing in mineral or timber land or other real estate; leasing property, collecting rents, managing office buildings, making investments of profits; leasing lands and collecting royalties, managing wharves, dividing profits; and in some cases investing the surplus, are engaged in "carrying on or doing business" within the meaning of the statute.

A corporation may complete its organization and sell its capital stock for cash without incurring liability, but other activities, such as entering into contracts for the purchase of property or construction of a plant are corporate business acts, and constitute doing business. In other words, it is not necessary that a company be actually engaged in the manufacture of its intended product or that it be actually creating profit or gain to incur liability. The making of contracts, buying of materials or machinery, constructing buildings, employing and discharging of individuals are necessary business acts leading to the more profitable end of manufacturing certain products.

The letting of a contract and construction of a hotel preparatory to engaging in the hotel business is sufficient to incur liability.

A corporation organized for the purpose of, and actually engaged in, buying mineral or timber land or other real estate and holding it with a view to future sale at an advance is carrying on or doing business.

A corporation organized for the purpose of owning and leasing real estate which has leased all of the property under its control is

[18] The last two paragraphs of this regulation defining a corporation that has "substantially retired from business" and citing an example of such a corporation, did not appear in Art. 10, Reg. 50.

[19] For court decisions bearing on liability and non-liability to tax, see *Income Tax Procedure*, 1918, pages 654-659.

still engaged in doing business unless, under the terms of its lease, its activities have been reduced to the mere receipt and distribution of the avails of the leases at the actual cost of so doing. If it is still maintaining its organization for the purpose of continued effort in the pursuit of profit and gain it is doing business.

A corporation owning or managing real estate which leases all of its property, but under the terms of the lease is required to maintain or keep the property in repair, is doing business.

No particular amount of business is required in order to bring a company within the terms of the act.

A corporation engaged in mining or in developing and speculating in mineral lands is doing business.

A corporation engaged in buying and selling securities or other property is doing business, even though for a period it makes no purchases or sales because of unfavorable market conditions.

A corporation formed to take over miscellaneous stocks, bonds, or other property (as of an estate), to negotiate sales of various items from time to time as opportunity and judgment dictate, and to distribute the profits from time to time as liquidation is effected, is, while so engaged, carrying on or doing business.

A parent corporation which finances or manages the operations of its subsidiaries is doing business.

A so-called holding company which, under its charter, is authorized to and does, in addition to receiving and distributing the avails of the property or securities, held by it, finance the operations of its subsidiaries, is engaged in doing business.

A corporation organized for the purpose of taking over and holding securities, timber land, coal lands, or other real estate, is held to be doing business, if it makes investments or reinvestments of its surplus income or funds in excess of an amount necessary to maintain its original investments.[20] (Reg. 64, Art. 12.)

"NOT DOING BUSINESS" ILLUSTRATED.—

REGULATION. Holding companies as distinguished from parent corporations, and corporations all of whose property and business is operated by, or is in the hands of, a receiver or the Alien Property Custodian, are not doing business.

A holding company is defined as one whose corporate powers are limited to the mere owning and holding of property and distribution of its avails, or one which, although incorporated for the purpose of doing business as defined in article 11, has substantially retired from the business for which it was organized and has reduced its activities to the mere ownership and holding of property, distributing

[20] This regulation elaborates Art. 11, Reg. 50, the most important additions thereto being that "no particular amount of business is required in order to bring a company within the terms of the act."

its avails, and doing only such acts as are necessary to the maintenance of its corporate existence and the private management of its purely internal affairs.

A holding company, as above defined, will not be considered to be doing business by reason of the reinvestment of its surplus income or funds to the extent only of maintaining its original investments.[21] (Reg. 64, Art. 13.)

Corporations which are not subject to the tax.—

LAW. Section 1000. . . . . (b) The taxes imposed by this section shall not apply in any year to any corporation which was not engaged in business (or, in the case of a foreign corporation, not engaged in business in the United States) during the preceding year ending June 30, nor to any corporation enumerated in section 231, nor to any insurance company subject to the tax imposed by section 243 or 246.

If, on June 30, 1923, or prior, a corporation formally decides to liquidate, no return need be made thereafter.

PERIOD OF DOING BUSINESS DETERMINES TAX LIABILITY.[22]—

REGULATION. The tax being payable in advance does not apply to any corporation which was not engaged in business during any part of the fiscal year preceding the year for which the tax is due, but if it was in business even one day of the preceding year and

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[21] **[Former Procedure]** T. D. 2429, dated January 4, 1917, held that a holding company (having several subsidiaries), the only business of which was "to receive dividends and interest from the operating companies, pay interest on its own indebtedness and distribute its surplus income as dividends among its own stockholders," is engaged in business within the meaning of the act of September 8, 1916, and is subject to the capital stock tax. It will be noted that this decision has been reversed and corporations with activities limited to those described are not liable to the tax.

A corporation which had leased all its properties to another corporation upon the consideration that the latter would pay direct to the first corporation's stock and bondholders a certain rental, and the only business of which was to issue stock and bonds at the request of the lessee, was not "carrying on or doing business" within the meaning of the act of 1909. (*Anderson v. Morris & Essex Railroad Co.*, 216 Fed. 83, 132 C. C. A. 327.)

[22] **[Former Procedure]**

REGULATION. A corporation owning a railroad controlled and operated by the Government is exempt from liability for a given tax year only in case it does no business during such year. The liability of a corporation which actually does business is not affected by the control over its railroad exercised by the Government. . . . . (Reg. 50, Art. 20.)

For detailed procedure regarding railroads, see Reg. 50, Arts. 20 and 21; T. D. 2800 (March 12, 1919); and T. D. 3156 (April 11, 1921).

one day of the taxable year it is subject to the tax. There is no relation between the amount of the tax payable and the length of time the corporation was in business. A corporation engaged in business during a part of the preceding year, but not engaged in business at the beginning of the taxable year, is not required to make any return if it is dissolved or in process of dissolution, but if it is only temporarily inactive and subsequently during the year reengages in business it should file a return in the month in which it recommences business and pay the tax due from the first of such month to the end of the taxable year. A corporation organized and beginning corporate activities on or after July 1 is not subject to tax for the remainder of the taxable period in which the company was organized, unless as of *July 1*, it takes over the business of an organization which was subject to capital stock tax, in which event the new corporation is required to file a return and pay the tax. Also see article 32 relative to election to be taxed as a corporation. In the case of foreign corporations "engaged in business" means the transaction of any business within the United States. (Reg. 64, Art. 28.)

Exempt corporations.—In addition to corporations not "doing business" the thirteen classes of corporations enumerated in section 231 of the income tax law, insurance companies (excepting mutual companies subject to the income tax imposed by section 230)[23] and corporations the fair value of whose capital stock for the preceding year does not exceed $5,000,[24] are exempt.[25]

Return by corporation claiming exemption.—

Regulation.[26] As corporations are generally organized to do business every existing company is presumed to be subject to the tax unless satisfactory evidence is submitted showing that it is exempt. Corporations claiming exemption should fill out Form 707 but instead of computing the tax should enter in the space provided for the computation the notation "Exemption claimed." In all such cases the return so filled out must be filed with the collector, together with a comprehensive statement of the reasons for claiming exemption.

If exemption has been allowed for the preceding taxable year and there has been no change in the status or conditions of the company

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[23] See I-33-463; L. O. 1104.

[24] See page 1479.

[25] See Reg. 64, Art. 29.

[26] **[Former Procedure]** The first sentence of this regulation, stating in effect that the burden of proof of exemption is on the taxpayer, was not included in **Reg. 50, Art. 28.**

then the first 13 lines of Form 707 should be completed and a statement attached to the effect that exemption is claimed for the same reasons as for the previous year and that the same status and conditions of the company exist for the taxable period in question. In this way the records of the collectors' offices will be complete and corporations will avoid requests for the filing of returns and unnecessary correspondence. The determination of liability rests with the Commissioner of Internal Revenue and without complete information it is impossible to make a decision. (Reg. 64, Art. 31.)

Rate and computation of tax for domestic corporations.—

LAW. Section 1000. **(a) . . . . (1) Every domestic corporation shall pay annually a special excise tax. . . . . equivalent to $1 for each $1,000 of so much of the fair average value of its capital stock for the preceding year ending June 30 as is in excess of $5,000. In estimating the value of capital stock the surplus and undivided profits shall be included; . . . .**[27] .

REGULATION. The tax is imposed at the rate of $1 for each full $1,000 of the fair average value of the capital stock of the corporation in excess of the prescribed deduction of $5,000.

The tax being payable in advance is prospective and is measured by the fair average value for the year preceding the taxable year, not the fair value of the average capital stock. If a corporation begins business within the preceding year or increases or decreases its capital within the preceding year, thereby materially changing the fair value of the capital stock, the tax is measured by the fair value of the capital stock outstanding at the date of incidence of the tax (June 30). Therefore, while Form 707 permits, as a matter of convenience to the taxpayer, the using of a balance sheet as of a date prior to June 30, but not prior to the preceding December 31, if there is a material change in the condition and affairs of the company affecting the fair value of the capital stock subsequent to the closing of the

[27] [Former Procedure] Both the 1916 and 1918 laws imposed this tax on insurance companies.

1918 LAW. Section 1000. . . . . (b) In computing the tax in the case of insurance companies such deposits and reserve funds as they are required by law or contract to maintain or hold for the protection of or payment to or apportionment among policyholders shall not be included.

(c) . . . . and in the case of every such domestic [mutual insurance] company the tax shall be equivalent to $1 for each $1,000 of the excess over $5,000 of the sum of its surplus or contingent reserves maintained for the general use of the business and any reserves the net additions to which are included in net income under the provisions of Title II, as of the close of the preceding accounting period used by such company for purposes of making its income tax returns.

Mutual life insurance companies have been held subject to capital stock tax under the Revenue Act of 1918. (I-33-463; L. O. 1104.)

books and prior to the date of the incidence of the tax (June 30), the financial condition should be reported under Exhibit A as of June 30, giving effect to such material changes.[28] Under Exhibit B, the market value will be determined by multiplying the average market price per share for the period during which the capital stock as of June 30 has been outstanding by the number of shares outstanding as of that date.

No deduction is allowed corporations organized in the United States for capital invested outside of the United States. If the corporation is doing business it is taxed on its entire capital stock even though most of it may not be employed in the business. (Reg. 64, Art. 14.)

It should be noted that the foregoing regulation provides that in cases where there is a material change in the condition and affairs of the company affecting the fair value of the capital stock subsequent to the closing of the books and prior to the date of the incidence of the tax at June 30, the financial condition should be reported under Exhibit A as of June 30, giving effect to any such material changes.

Methods of ascertaining fair value.—

Regulation. The fair average value of the capital stock for the purpose of determining the amount of the capital stock tax must not be confused with the market value of the shares of stock where it may be necessary to determine such value under other provisions of the revenue laws. The fair average value of the capital stock, the statutory basis of the tax, is not necessarily the book value or the value based on prices realized in current sales of shares of stock or the value determined by capitalization of earnings.

Form 707 provides Exhibit A for the book or fair value of the assets, Exhibit B for the market value of the shares, and Exhibit C for the value of the capital stock based on the capitalized earnings. All information called for must be given in every case where it is procurable. The fair average value of the capital stock of a corporation and the tax payable thereon shall be determined from a consideration of the data contained in the return as well as all elements and factors affecting values, which should be harmonized so far as possible in the ultimate fair value found. Fair value is required irrespective of the exhibit used or the method employed in its determination.

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[28] [Former Procedure] This sentence was not included in Reg. 50, Art. 13.

EXHIBIT A.—The character of the assets is probably the most important factor in determining the reliability of the value reflected by this exhibit as being indicative of the fair value of the capital stock. If the market value of the assets be established the fair value of the capital stock is held to be not materially less than the fair market value of the net assets. Attempts to average the assets as a means of estimating the fair average value of the capital stock are not permitted.

EXHIBIT B.—The market is regarded as a factor, but only of importance when the underlying factors upon which the market has been established are sound in all essential particulars.

EXHIBIT C.—The weight attaching to this exhibit is largely dependent upon the nature of the business and character of the assets.

In capitalizing the net earnings of the corporation, which should reflect the true earning capacity, the officers should use a rate fairly representing the conditions obtaining in the trade and in the locality, with due regard to other important factors, including the worth of money. But such fair value must not be greatly at variance with the reconstructed book value shown by Exhibit A, unless the corporation is materially affected by extraordinary conditions which support a lower valuation. In any such case a full explanation must accompany the return. The commissioner will estimate the fair value of the capital stock in cases regarded as involving any understatement or undervaluation.

The fair value of the capital stock, as provided under section 1000(a) (1) of the Revenue Act of 1921, and invested capital under the excess-profits tax provisions of the Revenue Act of 1921 are not necessarily the same.

For the purpose of capital-stock tax the fair value of the capital stock is estimated, and is predicated on present values, including actual appreciation of property, whether realized or unrealized, and such intangible assets as good will, trade-marks, and patents to the extent reflected by the earning power, whereas, for the purpose of excess-profits tax, the invested capital is based upon the actual investment of the stockholders in the corporation, irrespective of the present value of its assets. In the case of the capital-stock tax the fair value looks to the present net value of the assets, irrespective of the amount of the investment of the stockholders.[29] (See art. 863, Reg. 62.) (Reg. 64, Art. 15.)

According to the foregoing regulation, the fair value of the capital stock for the purpose of the capital stock tax is

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[29] [Former Procedure] This regulation enlarges on Art. 14 of Reg. 50, in which the brief descriptions of the purpose of the Exhibits A, B and C did not appear at all.

estimated, and is predicated on present values, including actual appreciation of property whether realized or unrealized, together with intangible assets to the extent reflected by the earning power.

There is required to be included in Exhibit A of the return practically everything carried upon the company's books. That being the case, due effect should be given to depreciated assets.

Even though depreciation has been taken to the extent allowed by the federal income tax regulations, the fair value of a plant may be much less than the depreciated book value. The factor of obsolescence is allowed for in an appraisal of the fair value.

A good test of the value of capital stock can be made if one views it as a prospective purchaser. At such times, the most optimistic theorist finds it necessary to scale down, not only plant values, but such items as accounts receivable and inventories.

Inventories valued at "cost or market, whichever is lower" may still be much higher than is fair in appraising the value of capital stock.[30]

Regulation. The surplus and undivided profits of a corporation must be included in estimating the fair average value of its capital stock. If the fair average value be determined from the book value, the surplus and undivided profits are included in the assets, if from sales, they are necessarily a factor in determining the market price, and if from net income, they are reflected to a greater or less extent in the earnings. (Reg. 64, Art. 16.)

The edition of form 707 promulgated for use in preparing returns for the year ending June 30, 1923, requires that the balance sheet to be furnished under Exhibit A be as of June 30, 1922, if possible, but in no case earlier than December 31 of the preceding year. Since such a balance sheet will not in many cases reflect the "average" book value for the year, especially when material changes have been made in

[30] The subject of inventories is treated fully in *Auditing, Theory and Practice,* Vol. I (3rd edition), by R. H. Montgomery, Chapters VIII and IX.

either the assets or liabilities, additional statements which will reflect the desired value may need to be furnished.

Briefly stated, a corporation should follow this procedure:

Fill in the answers called for by Exhibits A, B or C—any or all. If the result does not produce a fair value, additional statements supporting the value claimed to be fair should be prepared and attached to the form. It is wholly unnecessary for a corporation to accede to an assessment which overestimates the "fair average value of its capital stock."

The exhibits called for in form 707, which have already been briefly described in article 15 of Regulations 64, are described in more detail in the official instructions on page 4 of the return form as follows:

EXHIBIT A: CONDENSED BALANCE SHEET.—

Furnish under Exhibit A a condensed balance sheet as of June 30, 1922, if possible, but in no case earlier than December 31, 1921.

"Books of account."—These columns must show the amounts as carried in the taxpayer's books of account.

"Fair value."—Refer to article 1 above, defining the value required, and in the event that the columns "Books of account" contain any overstated or understated values, show herein the actual values. In the case of mines, oil and gas wells, other natural deposits, and timber, valuations established as the basis of depletion in computing income and profits taxes should be shown in the "Fair value" column. If any different valuation is claimed than reported in the "Fair value" column it may be stated and should be supported by reasonably conclusive evidence.

"Difference."—These columns will show the difference between the columns "Books of account" and "Fair value." Any material differences *must be explained* in such manner as to enable the Commissioner of Internal Revenue to determine if they are proper and acceptable. For this purpose the differences shown herein need not be covered by corresponding adjustments in the taxpayer's books of account.

"Profit and loss."—If the "Profit and loss" balance is a debit, the amount should be shown in red.

Reserves for the payment of future dividends, whether declared or not, will not be considered as liabilities, but a reasonable amount to cover the preceding dividend period may be so considered if the dividend has been declared and not disbursed. If deducted, show date declared and date of actual payment.

Exhibit A of form 707 calls for the deduction of treasury stock from the gross amount of capital stock so that the net outstanding stock is shown. This is the correct basis for valuation of the stock. Stock in the treasury has in effect been paid off so far as the former holders thereof are concerned. Therefore, only the stock still outstanding in the hands of stockholders represents capital actually employed in the business.

It must be borne in mind that the tax is to be computed on the basis of "the fair average value of the capital stock for the preceding year." [Law, section 1000 (a-1).] If the book value of the shares is used as a proper measure for taxation, and if a net profit has been earned during the preceding year, the *average* value of each share will be less than the value at the end of the year.

A statement of net worth, prepared by adjusting book values to actual values, is of great service in ascertaining the fair value of corporate stock, but book value is only one factor.

It is, however, not always practicable to place a "fair value" on fixed assets; in fact it is usually impossible to assign any value to such assets other than the book value. Also, the value of manufactured or partly manufactured goods on hand is extremely difficult of determination, especially in the case of an unprofitable concern. The fair value of such goods at a given date is certainly influenced by the profitableness or otherwise of the manufacturing operations.

Capital stock is not worth book value, even when book values are adjusted, unless recent earnings produce, or future earnings promise, an adequate return. In a vast majority of cases when earnings of one or more years are poor, there is a reflection of this unsatisfactory condition in the fair value of the capital stock. In such cases or when the earnings have fluctuated greatly or when the average annual earnings, capitalized at a proper rate, do not fully support the book value or the adjusted book value, it is quite evident that the real "fair value" is an amount less than the book

value and possibly more than the capitalized income value, depending upon the character of the assets, i.e., quick or slow turning, liquid or otherwise, etc.

Buyers simply will not pay book value for the shares of a corporation unless a fair average annual return is being, and can be, realized on such book value.

> Generally speaking, book value has little relation to market price. Taking a number of successful industrial corporations at random it appears that American Locomotive is now selling nearly 100 points behind its tangible asset value, International Harvester and American Woolen 80 points behind, Corn Products Refining 60 points behind, Westinghouse Electric 1.5 points behind . . . .
>
> Theoretically the market price of a security is fixed by the going rate of interest and the return to an investor which it is generally expected the security will yield. (*Barrons,* October 9, 1922.)

In a recent case[31] the United States District Court for the Southern District of New York held, in estimating the "fair average value of the capital stock for the preceding year," that:

> DECISION. . . . . the collector was confronted with the proposition of determining the value of the corporation's business and property as an entirety and as a going concern, and in doing so had the right to look to the net worth of the corporate assets, including its surplus and undivided profits, as shown by its books; also to the franchises, good will, outstanding contracts, the earning capacity of the corporation and the market value of its share stock over the preceding year, and, after having done so, was authorized to arrive at a value for its entire capital stock, representing the enterprise as a going concern, according to his best judgment, and that the value, so ascertained, would be the "fair average value of the capital stock for the preceding year," by which the tax by the terms of the statute is to be measured. . . . .

In this case the taxpayer had reported as the measure of fair value, the book value, that is, the aggregate of its capital and surplus accounts. The market value of the shares being in excess of the book value, the Commissioner imposed an additional tax based on market value. Later the additional tax was reduced from $8,734.50 to $3,415.00, indicating that

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[31] *Central Union Trust Co. v. Edwards,* 282 Fed. 1008, May 25, 1922.

the final assessment was on a basis considerably under the market value.

It is not usual for more than a small percentage of the shares of trust companies to change hands during a year. Therefore in selecting market value the Commissioner must have assumed that a very small number of sales constituted a proper criterion of value. This is contrary to the practice of the Treasury in other cases, in which it has been held that nothing less than a sale of a majority interest would be considered. In one case in which more than 15 per cent of the stock changed hands in one year, the Commissioner said: "This price (that paid for the 15 per cent) did not have in contemplation the purchase or sale of a majority interest, and was not established in active market trading."

The decision in the Central Union Trust case has been appealed and may not stand. It is, however, interesting to note that the court disregarded book value and considered those factors which usually determine the price arrived at by willing buyers and willing sellers. It is of particular interest in its effect on the Treasury's method of determining the value of the stocks of close corporations. The basis usually used is book value. The court points out that book value must be disregarded as a sole factor and that there must be considered "favorable contracts, amount of business done, and its profitable character . . . . and the market value of the stock. . . . ."

> . . . . If the value of good will and franchises, earnings and market value of shares are eliminated as factors of value, then the computation of value would in no sense be an estimation; the value would be the exact value, rather than the fair value, and it would have been made determinable as of the end of a fiscal year, rather than by "the fair average value of the capital stock for the preceding year. . . . ."

It is clear that the decision seriously weakens the procedure of the Treasury regarding close corporations. If market value *must* be considered, the fair value of the capital stock of a corporation, whose shares do not happen to have an active market,

may be compared with the quotations for shares of similar companies, in which there is an active market.

EXHIBIT B: QUOTATIONS OR OUTSIDE SALES PRICES.—

Furnish under Exhibit B the prices quoted on a recognized stock exchange or on the New York curb, or the prices at which outside sales were made if the stock is not listed, for the period of 12 months ending June 30, 1922.

If the stock is listed the name of the exchange from which reported quotations are taken must be shown in the space provided therefor, and the prices reported will be the mean of the highest and of the lowest bid[32] price during each month, from which the average for the year will be obtained. If the taxpayer prefers, a schedule may be attached to this return showing the highest and lowest bid price at which stock was quoted for each day of the year and the average obtained therefrom.

If the stock is not listed and outside sales have been made at prices known or determinable by the officers making this report, such prices will be reported herein. A statement of the number of shares involved and the conditions under which sales were made at other than exchange quotations must accompany this return. Sales to employees or directors for qualifying purposes, or sales which are restricted as to resale, or sales at prices otherwise specially influenced, will not be considered representative of the fair value of the entire capital stock and should not be included.

In the column "Number shares outstanding" should be shown the total number of shares outstanding at the close of each month. The average value per share will be determined as follows:

First. If no change occurred in the number of shares outstanding during the year, total the quotations or sales prices for the months reported and divide by the number of months in which quotations or sales prices are shown.

Second. If any change occurred in the number of shares outstanding during the year, multiply the average market price per share for the period during which the capital stock as of June 30, 1922, has been outstanding by the number of shares oustanding as of that date.[33]

[32] This is a correct basis. Reg. 38, 1916, Art. 6 (a), called for averaging *highest* bid prices.

[33] [Former Procedure] Form 707 for the tax year 1920 provided that when any change occurred in the number of shares outstanding during the year, the value per share was to be determined by dividing the total of the value of the shares outstanding each month based on the reported prices, by the sum of the total number of shares outstanding during the year.

Form 707 for the tax years 1921 and 1922 provided that such value should be ascertained by dividing the total of the quotations or sales prices for each month, by the number of months used in the computation.

The procedure prescribed for the year 1920 resulted in a more correct average value for the year and was consequently more equitable.

When physical values are not supported by earnings.—As heretofore stated, capital stock may not be worth book value when the earnings are low. In a recent case it was decided that the preferred and common stocks representing physical property were valueless because the earnings were not sufficient, and there was no reasonable chance that the earnings would be sufficient, to yield any return on the investment.[34]

Exhibit C: Annual income.—

Furnish under Exhibit C the annual income and other data for the five fiscal years ended with the close of the taxpayer's fiscal year, or for the period during which the corporation has been engaged in business if for a shorter period.

"Net income."—In this column will be shown the income returned for the purpose of the income tax and excess profits tax.

"Deductions" and "Additions."—Refer to article 1 of these Special Instructions, and show in these columns such amounts as should be deducted from or added to "Net income" to arrive at the adjusted income which may be capitalized to determine the fair value of the capital stock. A comprehensive analysis of any amounts reported therein should be attached to this return. Some of the principal items frequently requiring adjustment are:

Deductions:

Income and profits taxes not deductible in computing income subject to tax.

Interest charges not deductible in computing income subject to tax.

Losses not fully deductible in computing income subject to tax.

Additions:

Dividends from other corporations not included in computing income subject to tax.

Income from securities of a State, municipality, or of the United States, not included in the income-tax return.

The difference between depletion allowed in determining net income subject to Federal income tax and the actual depletion based on cost.

Expenditures made for additions and betterments, or reserves for such purposes, charged against income, whether direct or through expenses.

[34] Report of Board of Arbitration which decided that the Dominion of Canada should pay nothing for the stocks of the Grand Trunk Railway. Decision upheld Nov. 9, 1922, on appeal to the Privy Council of Great Britain.

"Adjusted income."—This column will reflect the amounts resulting from the adjustment of the amounts shown in the three preceding columns.

"Number of shares."—Herein should be given the total number of shares of all classes of stock outstanding at the close of each fiscal year.

"Dividends declared."—Herein should be reported the percentage of dividends declared on each class of stock outstanding each year. The amount represented by the percentages shown in this column must not be deducted from the columns "Net income" or "Adjusted income."

"Depreciation."—Hereunder will be reported the amount actually charged against income each year in the taxpayer's books of account for depreciation.

Capitalizing net income.—The officers making the return will capitalize the average annual income on a percentage basis that fairly represents, under the conditions obtaining in the trade in the locality, what representative enterprises must earn in order to maintain their stock at par. In other words, if enterprises engaged in a similar business must on the average earn 12 per cent on their issued capital stock to keep the value of their stock at par, the net income should be capitalized by dividing it by .12.

Some of the best stocks in this country, which are valued for the purpose of this tax at their average quotations on the New York Stock Exchange (a fair basis in many cases, as the sales are numerous and actual transactions between willing buyer and willing seller are after all the best indication of value) have during recent years shown 30, 40 or even 50 per cent per annum earned on their par value, though their selling prices in the open market have often not been above par.

An industrial stock to be valued at par should have net tangible assets equal to par, unless the average earnings exceed 20 per cent per annum on the capital stock.

If the earnings are considerably above 20 per cent per annum, fair value may sometimes be more than par, but the physical assets must always be considered. If earnings are on a downward trend, the average may be disregarded. Only in exceptional cases should the item of goodwill be a factor in valuations under this act. If the goodwill actually has

a present value, it will be reflected in the earnings shown in Exhibit C.

An excise tax imposed on the privilege of doing business as a corporation should be construed in favor of the taxpayer, and speculative values and other items which sometimes influence high prices for shares should be ignored.

In considering earnings as a basis for valuation, it should be remembered that if the earnings include unusual profits, which it is not expected will recur periodically, a prospective purchaser of the stock would not pay a price based on capitalizing such extraordinary profits. Unless Exhibit A supports the capitalized value of profits of an unusual nature, it would be fallacious to capitalize them for valuation purposes.

Income and excess profits taxes should be deducted before earnings are capitalized for the purposes of the excise tax.

When net profits of past years are used in calculating average earnings, net losses must also be used in the computation.

Capitalization.—Since many corporations have more than one class of stock, provision must be made for a calculation which gives due weight to the fair value of the entire outstanding capitalization. It is believed that a short and simple rule will settle any apparent difficulties in determining a proper valuation.

As to preferred stock.—If preferred stock has a market value, the actual number of shares of preferred stock outstanding multiplied by the average market value of each share will produce the desired result. If preferred stock has no market value, but if the book value is in excess of par, and if some value is ascribed to the common stock, the preferred stock should be listed at par.

There are, however, many classes of preferred stocks. When there is no cumulative provision as to dividends; no, or only partial, preference as to assets; a low rate of dividend, or other factors which, as compared with similar preferred stocks *having* a market value, would tend to lower the fair value of

the preferred stock, full weight must be given to all factors and that value must be placed upon each share of preferred stock which can be supported as being a fair value.

As to common stock.—If it be borne in mind that the one base of the tax is the *net worth* of the corporation, it will simplify the calculations whenever more than one class of stock is concerned. In all cases (exclusive, of course, of corporations the market value of whose shares can be ascertained) the fair value of a corporation's entire capitalization will have to be determined. This should be done regardless of the different classes of shares, if any. After a trustworthy estimate has been made, the aggregate valuation placed upon the one or more classes of preferred stock should be deducted; the balance represents the proper valuation for the common stock.

Deductions and credits.—

Law. Section 1000. (a) . . . . (1) . . . . a . . . . tax . . . . equivalent to $1 for each $1,000 of so much of the fair average value of its capital stock . . . . as is in excess of $5,000.[35]. . . .

Returns

Time of making returns.—

Regulation. It shall be the duty of every corporation on or before the 31st day of July in each year to make a return to the collector of the district in which its principal place of business is located. If any corporation fails to make and file a return within the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return, the collector or deputy collector shall make the return from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the commissioner may, from his own knowledge and from such information as he can obtain through testimony, or otherwise, make a return or amend any return made by a collector or deputy collector. Any return so made and subscribed by the commissioner, or by a collector or deputy collector and approved by the commissioner, shall be prima facie good and sufficient for all legal purposes. If on account of sickness or absence of the officer of the corporation charged with making the return, it is impossible to prepare and

[35] Prior to July 1, 1918, the exemption was $99,000.

file a return on or before the 31st day of July (the due date), the collector, upon application in writing, may allow an extension of time not exceeding 30 days from July 31, in which to file the return. *If extension is granted, the letter of the collector should be attached to the return.* . . . .

On no account is the Commissioner of Internal Revenue or the collector authorized to grant an extension of time in which to file capital stock returns in excess of 30 days from July 31, the due date. If for reasons, other than absence or sickness, beyond the control of the officers making the return, it becomes impossible to file a completed return within the time prescribed by law, a tentative return may be filed. (Reg. 64, Art. 20.)

Regulations 64 require that *all* corporations shall file returns, whether exempt or not. This follows the requirement of Regulation 50, revised, article 16, under the 1918 law.

Tentative return.—

Regulation. The filing of a tentative return within the prescribed period will avoid the penalty for delinquent filing, but will not authorize the withholding of the tax. The regulations do not permit the filing of a tentative return to stay indefinitely the filing of a completed return and the collection of the tax due. Therefore, if a tentative return is filed it should be clearly marked "Tentative Return" and should be prepared in as complete a manner as possible, including, among other information, a basis for the computation of the tax—that is, an estimate by the officers of the corporation of the approximate fair value of the capital stock in order that an initial assessment may be made. When the completed return is filed, it should be clearly marked "Completed return," showing that a tentative return was filed. Such action will prevent duplicate assessments and ordinary penalties. In every case a statement should be attached to the tentative return, indicating the approximate date the completed return may be expected. Upon receipt of the completed return any adjustment necessary in the assessment of the correct tax due will be made. (Reg. 64, Art. 21.)

Verification of return.[36]—

Regulation. The return and any separate statement submitted therewith must be verified in the form printed on page 3 of the return. In the absence of the president or treasurer, or both, other responsible

[36] [Former Procedure] Regulation. It shall be the duty of every corporation liable to the tax . . . . to make a return verified by oath . . . . (Reg. 50, Art. 33.)

Regulations 64, it will be noted, make an exception based on section 1303 of the 1921 act.

officers may execute the jurat to avoid delinquency. However, if the amount of the tax covered thereby is not in excess of $10, the return may be signed or acknowledged before two witnesses instead of under oath. . . . . (Reg. 64, Art. 19.)

When return must be filed before information is available.—

RULINGS. Answering your letter of July 3, 1919, in which you make inquiry as follows:

> "What is the best procedure for reporting net income under exhibit C of capital stock tax returns, form 707, in the case of corporations whose fiscal year ends June 30, and who have not filed return for Federal income tax purposes before the time for filing capital stock tax returns has expired?"

you are advised paragraph 3, special instructions 1, page 4, form 707, states:

" . . . . and the taxpayer will complete each exhibit or state why the required data are not available."

The law provides that capital stock tax returns shall be filed during the month of July for the taxable period beginning July 1 and that the collector is empowered to grant an extension of thirty days beyond the due date of filing only in case of sickness or absence of the officer charged with the preparation of the return. You will therefore note there is no authority under the law for granting an extension for any reason beyond thirty days from July 31, 1919.

Capital stock tax returns should therefore be completed so far as practicable and filed with the collectors within the prescribed time with the statement that unavailable data will be furnished in a supplemental report at the earliest possible date.

In the case of any failure to make and file a return within the prescribed time a penalty of 25 per centum of the amount of the tax attaches, except that when the failure to file was due to a reasonable cause and not to willful neglect no such addition shall be made to the tax.

The above procedure will avoid any assertion of the penalty or question as to what constitutes a reasonable cause. (Letter to The Corporation Trust Company, signed by Deputy Commissioner J. Hagerman, and dated July 11, 1919.)

Exhibit (A) of Form 707 requires a statement of assets and liabilities as of June 30, 1922, if possible, but in no case earlier than December 31, 1921.

Therefore, where a corporation's fiscal year ended between July 1, 1921 and December 31, 1921, the procedure should be as follows:

If the fiscal year ended in July or August, 1921, a tentative return may be filed in accordance with Article 21, of Regulations 64, using the last available balance sheet. The completed return should be

filed shortly after the closing date of the corporation's 1922 fiscal year, showing in the books of account column figures as of that date, and using the "Fair Value" column to show estimated fair values as of June 30, 1922, the date of incidence of the tax.

In the event a tentative return is filed, it should be prominently marked "Tentative" at the top of page 1 and a statement attached advising the Collector when the completed return may be expected. To avoid the possibility of a duplicate assessment, the final return should be prominently marked "Completed," at the top of page 1, credit being taken for any tax paid on the tentative return.

If it is not desired to file a "Tentative" return, show book of account figures as of the latest closing date of the books, using the "Fair Value" column to show estimated fair values as of June 30, 1922, the date of incidence of the tax. Material differences will not be allowed, unless satisfactorily explained.

The Regulations as well as instructions accompanying Form 707 require that in the event a corporation has increased or decreased its capital stock between December 31, 1921 and June 30, 1922, the fair average value of the capital stock shall be determined for the amount of capital stock outstanding as of June 30, 1922, the date of incidence of the tax. (Letter to Prentice-Hall, Inc., signed by McKenzie Moss, Deputy Commissioner, dated June 22, 1922.)

It would be to the advantage of a taxpayer to file only a "completed" return. The filing of a "tentative" return entails the preparation of two returns with the possibility of failing to file the "completed" one and thus incurring a penalty. Of course, where conditions necessitate the filing of two returns, this should be done.

It should be remembered, moreover, that the tax cannot be imposed upon values at June 30, 1923, but only upon the "fair average value of the capital stock for the preceding year."

The law should be amended to provide ample time within which to file accurate returns.

Affiliated corporations, returns of.—

REGULATION. Although section 240 of the Revenue Act of 1921 requires a consolidated return for affiliated corporations for the purpose of income tax,[37] *for the purpose of capital stock tax each cor-*

[37] The 1921 law provides for filing either consolidated or separate income tax returns for tax years beginning on or after January 1, 1922. This change will have no effect on the capital stock tax returns.

poration must render a separate return in complete form. So-called subsidiary corporations, all or a part of the stock of which is owned by another corporation, must render separate returns, the same as every other corporation. No deductions from the assets are permitted on account of inter-company balances, and the shareholdings must be reported in the "Fair value" column at their actual worth at the time of making the return. No deduction is allowed in the return of one corporation for the tax paid by another.

If the fair value is determined by any method other than herein provided, the following requirements must be complied with: (a) The parent company must submit with its return a list of all subsidiaries and the districts in which the returns were filed; (b) the return of the subsidiary company must show the name of the parent company and the district in which the return was filed; (c) the method of determining the fair value, if other than by Exhibits A, B, and C, must be fully explained; (d) a copy of any agreement existing between parent company and subsidiary must be furnished, or a statement made that none exists; and (e) a combined balance sheet and a combined net income statement must be submitted for consideration in connection with any estimate of fair value made on behalf of the reporting corporation. (Reg. 64, Art. 18.)

RULINGS. In reply to your letter of May 17, 1919, requesting an interpretation of article 106 of Regulations 50,[38] regarding capital stock tax returns required of affiliated corporations, you are advised that the sentence, "If the fair value of its capital stock is based upon a consolidated report, a copy of such report should be attached to the capital stock tax return of each affiliated corporation," refers to each corporation of an affiliated group, that is, the parent company as well as each subsidiary.

Article 101, Regulations 50,[39] requires every domestic corporation to file a return regardless of the par value of its capital stock unless specifically exempt under section 231.[40] An exemption of $5,000 is allowed.

In many cases, as for instance, in the case of selling agencies separate corporations are formed in order properly to handle certain business under various state laws and in reality are branches or departments of the parent corporation. The business is controlled by the parent corporation and the result of operations is a matter of bookkeeping.

The capital stock tax being imposed upon the fair value of the capital stock of corporations it makes little difference by what method such fair value is determined. Therefore, if affiliated corporations

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[38] Art. 35 of Reg. 64 is substantially the same.

[39] Art. 20 of Reg. 64.

[40] The 1921 law also exempts from this tax insurance companies taxable under section 243 or 246.

are best able to determine the fair value of the respective companies through a consolidated report such privilege is permitted by the Department, but it seems preferable to leave this to the corporations interested subject to approval by the Commissioner of Internal Revenue rather than attempt to outline a specific method that would apply to all. (Letter to The Corporation Trust Company, signed by Deputy Commissioner J. Hagerman, and dated June 2, 1919.)

Referring to office letter of June 2, 1919, it has come to the attention of this office that a number of taxpayers are construing this letter as granting special privileges not intended and not permitted under the law and regulations. This letter properly interpreted reflects the views of this office and is applicable to such cases. The taxpayers, however, may have been misled by the wording of the heading, which reads:

"Consolidated Returns of Affiliated Corporations"

and it is suggested with a view to avoiding further misunderstanding that the heading be revised, as follows:

"Returns of Affiliated Corporations based upon a Consolidated Report."

The difficulty of outlining a general ruling that covers all questions relating to affiliated corporations should be appreciated and the taxpayer must realize that the tax is imposed upon the fair value of the capital stock of each individual corporation as disclosed by the facts in a given case, regardless of corporate affiliations. Only under certain conditions are corporations permitted to arrive at the fair value of the capital stock of the respective companies through a consolidated report, that is, where the fair value cannot be determined independently.

In interpreting the letter above mentioned, distinction must be drawn between the word "return" and the word "report." Under all circumstances individual returns are required of every corporation regardless of the basis used in arriving at the fair value. (Letter to The Corporation Trust Company, signed by Deputy Commissioner J. Hagerman, and dated November 11, 1919.)[41]

Payments

Time of payment of tax.—The tax is assessed annually in advance.

DECISION. (Digest from T. D. 3160.) The capital stock tax imposed by the Act of September 8, 1916, is not illegal because as-

[41] **[Former Procedure]** For a statement of the additional returns required by the Treasury for the taxable year ended June 30, 1919, on account of retroactive features after the 1918 law, see *Income Tax Procedure,* 1922, page 1552.

sessed and collected in advance under regulations of the Treasury Department, the act, by sections 407 and 409, contemplating that a corporation must pay a tax on its capital stock for the preceding year in order to do business for the coming year.[42]

Regulation. All assessments shall be made by the commissioner. The collector shall within 10 days after receiving any list of taxes from the commissioner give notice to each corporation liable to pay any tax stated therein, to be left at its place of business or to be sent by mail, stating the amount of such tax and demanding payment thereof. If such corporation does not pay the tax within 10 days after the service or the sending by mail of such notice, it shall be the duty of the collector to collect the tax with a penalty of 5 per cent additional upon the amount of the tax and interest at the rate of 1 per cent a month. See section 3184, Revised Statutes. A collector has no authority to extend the time for payment of the tax, and any extension granted by him will be at his own risk. All taxes are payable direct to the collector of internal revenue of the district in which return is filed. The collector may accept payment of the tax when the return is filed as an "advance collection," subject to any adjustment later found necessary, but no corporation is required to pay the tax until after notice and demand. However, the collection of the tax is facilitated where a corporation transmits with the return a check for the amount of tax due. Tax due from a corporation which has liquidated is legally collectible from the stockholders or others who have received its assets. (Reg. 64, Art. 35.)

No corporation is required to pay the tax until after notice and demand is received from the collector. However, the foregoing regulation, it will be noted, states that the collection of tax is facilitated where a corporation transmits with the return a cheque for the amount of tax due.[43]

Penalties

Failure to pay.—

Regulation. (a) Any corporation which fails to pay the tax when due and payable is liable to a penalty of $1,000. If it willfully refuses to pay or willfully attempts to evade the tax, it is liable also to a fine of $10,000.00 and costs and to a 100 per cent penalty to be added to the tax. See also article 39. (b) Any officer or employee of a corporation who in the course of his duty fails to pay the tax

[42] *Washington Water Power Co. v. U. S.*, 56 Ct. Cls. 76.
[43] [Former Procedure] This practice was discouraged under the 1918 law.

when due and payable is liable to a penalty of $1,000. If he willfully refuses to pay or willfully attempts to evade the tax, he is liable also to a fine of $10,000 and costs and to imprisonment for a year, and to a penalty of the amount of the tax unpaid or evaded. (Reg. 64, Art. 40.)

It is to be noted that the specific penalties of $1,000 and $10,000 are additional to the 5 per cent penalty and 1 per cent per month interest penalty for delay in payment, referred to in article 35. (See page 1497.)

Failure to make return and penalty for false return.—

Regulation. Any corporation which fails to make a return within the required time is liable to a penalty of $1,000. If it willfully refuses to make a return it is liable also to a fine of $10,000 and costs.

Any officer or employee of a corporation who in the course of his duty fails to make a return within the required time is liable to a penalty of $1,000. If he willfully refuses to make a return he is liable also to a fine of $10,000 and costs and to imprisonment for a year.

In case of failure to file a return on time,[44] a penalty of 25 per cent of the amount of the tax is added to it unless the return is later filed and failure to file it within the prescribed time is satisfactorily shown to the Commissioner to be due to a reasonable cause and not to willful neglect. This penalty is imposed by section 3176 of the Revised Statutes as amended. Two classes of delinquents are liable to this penalty: (a) Those who do not file returns and for whom returns are made by the collector or commissioner; and (b) those who file tardy returns and are unable to show reasonable cause for the delay. A taxpayer who files a tardy return and wishes to avoid the penalty must make an affirmative showing of all the facts alleged as a reasonable cause for failure to file the return on time in the form of an affidavit, which should be attached to the return. If such an affidavit is furnished with the return or upon the collector's demand, the collector, unless otherwise directed by the commissioner, will forward the affidavit with the return, and if the commissioner determines that the delinquency was due to a reasonable cause and not to willful neglect the 25 per cent penalty will not be assessed. If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return in the prescribed time, then the delay is due to "reasonable cause." (Reg. 64, Art. 41.)

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[44] Section 1311 of the 1921 law re-enacts section 3176, Rev. Stat., as amended by the 1918 law.

Under the foregoing regulation two classes of delinquents are liable to the penalties specified: those who do not file returns, and those who file tardy returns and are unable to show reasonable cause for the delay.

A taxpayer who files a tardy return and wishes to avoid penalty must attach an affidavit to the return when filed, showing that the delay was due to a reasonable cause.

Doing business without payment of tax.—

REGULATION. Every corporation which does business without having paid the tax is liable to a penalty of $1,000. A corporation paying the capital stock tax is not on that account exempt from any occupational tax. (Reg. 64, Art. 39.)

For other penalties see articles 40[45] and 41.[46]

Foreign Corporations

LAW. Section 1000. (a) . . . . (2) **Every foreign corporation shall pay annually a special excise tax with respect to carrying on or doing business in the United States, equivalent to $1 for each $1,000 of the average amount of capital employed in the transaction of its business in the United States during the preceding year ending June 30. . . . .**

Definition of foreign corporation.—

REGULATION. A foreign corporation is a corporation created or organized outside the United States as defined in article 9.[47] (Reg. 64, Art. 10.)

Scope of tax.—

REGULATION. The basis of the tax in the case of a foreign corporation is "carrying on or doing business in the United States." Foreign insurance companies are not liable to capital stock tax. (See Art. 29.)

A foreign corporation is carrying on or doing business in the United States if it maintains an agent or an office or warehouse in the United States or in any other way enters the United States for the purposes of its business. The purchase of supplies in the United

[45] See page 1497.
[46] See page 1498.
[47] See page 1470.

States in the furtherance of continued efforts in the pursuit of profit or gain is carrying on or doing business in the United States. (Reg. 64, Art. 22.)

It may be assumed that the term "doing business"[48] as applied to the activities of a foreign corporation in the United States, will be interpreted in the same manner as when applied to a domestic corporation doing business in another state.

Rate of tax.—

REGULATION. The tax is at the rate of $1 for each full $1,000 of the capital of a foreign corporation actually employed[49] in the transaction of its business in the United States, and is in all cases to be computed on the basis of the average amount of capital so employed during the preceding year ending June 30. The measure of the tax is accordingly different from that of domestic corporations which pay a tax measured by the fair average value of their capital stock. No deduction from the total fair average amount of capital so employed is allowed in computing the tax. (Reg. 64, Art. 26.)

Capital "employed" in the United States.—

REGULATION. The "capital employed in the transaction of its business in the United States" means the portion of the total capital, surplus, and undivided profits, of the foreign corporation, utilized for the purpose of doing business in the United States. A foreign corporation may have income from sources within the United States for the purpose of the income tax, and yet not have capital employed in the transaction of business here for the purpose of the capital-stock tax. Compare articles 92-94 and 316-329 of Regulations 62. A foreign corporation not actually doing business in the United States is not subject to tax, and accordingly, the investment of a part of its funds in United States stocks and securities will not constitute capital employed in its business in the United States. For the definition of "doing business" see article 11.[50] If a corporation does business in this country, then, although the mere investment of funds in United States securities is not such a taxable employment of capital, such investment will constitute capital employed in the transaction of business in the United States, if made in a subsidiary corporation which the foreign corporation uses as an instrumentality for the conduct of its own business in the United States. Thus the

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[48] See page 1474 *et seq.*
[49] The word "invested" was used in the 1916 law.
[50] See pages 1474-5.

investment of the funds of a foreign corporation in the purchase of facilities, although apparently independent, for the purpose of its business here, or the purchase of stock and securities of a subsidiary corporation for the same purpose, will constitute the employment of capital in the transaction of business in the United States. A foreign corporation may not escape taxation by organizing or purchasing the stock of another corporation to own the facilities which the foreign corporation needs in its business. See article 352, Regulations 62. (Reg. 64, Art. 23.)

If the foreign corporation does no business whatever in the United States, a separate domestic corporation being utilized for the carrying on of business in this country, it is obvious that the law imposes the capital stock tax only on the subsidiary. The mere ownership of the stock of an American corporation by a foreign corporation does not of itself constitute doing business by the latter in the United States.

"Capital 'employed' in the United States" illustrated.—

Regulation. A foreign corporation may employ capital in the transaction of its business in the United States in various ways. For example, the investment of funds in property in the United States used in its business, in stocks and securities of subsidiary corporations as explained in article 23, in bills and accounts receivable representing business done in the United States, in merchandise kept here for sale, in materials manufactured here, and in deposits in United States banks maintained for use in business here. Generally speaking, approximately such proportion of the entire capital of a foreign corporation will presumably be employed in the transaction of its business in the United States as the gross amount of its business in the United States bears to its total gross business, but this will not always be conclusive, since a corporation may conceivably transact a greater or less volume of business in one country than in another on the same amount of capital. (Reg. 64, Art. 24.)

Basis of tax, foreign corporation.—

Regulation. The measure of the tax is the average amount of capital employed in the transaction of business in the United States during the preceding fiscal year. It will usually be sufficient to determine the amount of capital so employed at the beginning of each year and the amount so employed at the end of such year, and to divide the sum of such amounts by two. Where, however, there

have been material changes in the amount of capital, the average amount should be determined with due regard to the times at which such changes occurred. A foreign corporation may, if it so desire, compute the average amount of capital employed on a monthly basis. (Reg. 64, Art. 27.)

Return by foreign corporations.—

REGULATION. Every foreign corporation carrying on or doing business in the United States shall make return on Form 708, irrespective of the amount of capital employed in this country in the transaction of its business. The capital actually employed in the transaction of the business of a foreign corporation in the United States and the tax payable thereon shall be calculated in accordance with the instructions on the form. (Reg. 64, Art. 25.)

Capital "employed" includes borrowed capital.—

RULING. Following question submitted on behalf our client the ——— Company, a foreign corporation. Referring Article 33 [Art. 18], Reg. 50,[51] is capital stock tax to be computed on entire amount of capital employed in this country irrespective of whether that capital consists in part of company's own capital and in part of borrowed capital? Kindly wire reply collect.

(Answer.) Your wire 25th. Capital stock tax is imposed upon capital employed irrespective of its nature whether borrowed, paid in or earned. (Telegram of inquiry from E. G. Shorrock & Co., Seattle, Washington, and the reply thereto, signed by Deputy Commissioner J. Hagerman, and dated October 30, 1919.)

Form 708, which provides for determining the capital employed in the United States by a foreign corporation, calls for a statement of the total capital, surplus and undivided profits, if available, (whether employed within or without the United States) and a statement of the assets employed in the transaction of business in the United States. The latter statement makes no provision for deducting liabilities incident to the transaction of business in the United States. In the case of a foreign corporation all of whose capital was employed in the United States, this would lead to the absurd result of showing a larger amount of capital employed in the United States than its actual total capital. Of course, if the corporation had

[51] See Arts. 20 and 23 of Reg. 64.

absolutely no liabilities the result would be the same in both statements; but as practically all corporations have liabilities, proper deduction should be made from the United States assets for the liabilities incident to the business in this country.

"Capital employed" obviously cannot mean gross assets, but must mean net assets, of the corporation's business in this country.

Miscellaneous

Inspection of returns.—

REGULATION. The returns upon which the tax has been determined by the commissioner, although public records, are in general open to inspection only to the extent authorized by the President. All bona fide stockholders of record owning 1 per cent or more of the outstanding stock of any corporation shall, upon making request of the commissioner, be allowed to examine the annual income returns of such corporations and of its subsidiaries, but such privilege of examination is personal and can not by power of attorney be delegated by the stockholder to another. Only such officers of any State as are charged with the enforcement of a State income tax law shall have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the secretary may prescribe, and then only in case the information is to be used by them in connection with such enforcement. Any stockholder who is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding 1 year, or both. See Treasury Decisions 2961, 2962, 3273, and 3277 for full particulars. (Reg. 64, Art. 33.)

Section 257 of the law, which referred specifically to income tax returns and on which the foregoing regulation is based, was by section 1000 (c) also made applicable to capital stock tax returns.

Abatement and refund of taxes.—The Commissioner of Internal Revenue will follow the same general procedure in

the treatment of fraudulent lists, statements or returns[52] and the collection, abatement, and refund[53] of capital stock taxes, as in the case of other internal revenue taxes.

Claims for credit not permissible.—

REGULATION. Section 252 of the Revenue Act of 1921 provides for a credit against additional income taxes due to previous overpayments of income or excess-profits taxes. The law does not authorize the credit of an excess payment of capital stock tax for a given period against an assessment of the same or other tax for a previous or subsequent period. A claim for abatement or refund for the excess assessment should be filed and payment made of the correct tax due for the previous or subsequent period. (Reg. 64, Art. 34.)

Medium of payment of tax.—Substantially, the same requirements as to medium of payment of tax are in force respecting the capital stock tax as are in force respecting the income tax.[54]

Dishonored cheques, procedure.—A taxpayer who pays his taxes by cheque is not released from his obligations until the cheque is paid at par, and in case the cheque is dishonored he becomes liable for the tax, and for all legal penalties and additions.[55]

Final determination and assessment.—Section 1312 of the 1921 law permits of an agreement in writing between the taxpayer and the Commissioner with respect to the amount of tax liability. It is provided that when such agreement is entered into, the case shall not be reopened by either the government or the taxpayer and no suit to overthrow it shall be entertained by any court, except upon a showing of fraud or mal-

[52] See section 3225 of the Revised Statutes, amended by the Revenue Act of 1918.

[53] See section 3220 of the Revised Statutes, amended by the Revenue Act of 1918; and section 3228 of the Revised Statutes, amended by the Revenue Act of 1921.

[54] See Reg. 62, Art. 1733; Reg. 64, Art. 37.

[55] See Reg. 64, Art. 38.

feasance or misrepresentation of fact materially affecting the determination of the tax liability.[56]

This is a reasonable and wise provision of law. It will, however, undoubtedly be more beneficial with respect to taxes other than the capital stock tax. The section of the Bureau which administers this tax has thus far succeeded fairly well in keeping the work up to date. It is the author's impression that cases in the capital stock tax section are not reopened as frequently as in some other sections of the Bureau.

Treasury decisions not necessarily retroactive.—Section 1314 of the 1921 law provides that Treasury decisions or rulings of the Commissioner or the Secretary which are not immediately occasioned or required by a decision of a court of competent jurisdiction, are not necessarily retroactive in effect. The question of retroactive appliance of such rulings is left to the discretion of the Commissioner with the approval of the Secretary. See page 207.

Limitations upon additional assessments and refunds.—Section 1322 provides that, notwithstanding the provisions of section 3182 of the Revised Statutes, assessments of additional taxes must be made within four years after such taxes become due. This provision applies only in the absence of fraud or an attempt to evade tax. In the latter case, assessment may be made at any time.

This section became effective upon the passage of the 1921 law, November 23, 1921, and, as it modifies the limitation in section 3182, Revised Statutes, additional assessments of capital stock tax for the tax period beginning July 1, 1919, may be made at any time before July 31, 1923.[57]

Section 1316 of the 1921 law amends section 3228, Revised

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[56] **[Former Procedure]** See Reg. 64, Art. 32.

[57] Taxes become due upon notice from the collector (see page 1497). Returns are due July 31. If the notice from the collector is sent out soon thereafter, the four-year period actually runs from some time early in August.

Statutes,[58] and provides for the filing of claims for refund of taxes erroneously or illegally assessed or collected at any time within four years next after payment of such tax.

Article 41, Regulations 64, states that this section [1316] except as modified by section 252, shall apply retroactively to claims for refund under the Revenue Acts of 1916, 1917, and 1918.

REGULATION. This section [1316] is retroactive in its effect. Any claim for the refund of taxes or penalties illegally assessed or collected under the Revenue Acts of 1916, 1917, or 1918, regardless of whether or not such claim was barred in whole or in part at the time of the passage of this act will be considered on its merits if presented within the four-year period specified in the foregoing section. (Reg. 64, Art. 42.)

Limitation upon suits.—Section 1320 of the 1921 law provides that no suit or proceeding for the collection of any internal revenue tax shall be begun after the expiration of five years from the time such tax was due, except in the case of fraud.[59] Suits begun prior to the passage of the 1921 law are not affected by this limitation.

Limitation of criminal prosecution.—Section 1321 of the 1921 law amends the act of July 5, 1884, and provides that no person shall be prosecuted, tried, or punished for any of the various offenses arising under the internal revenue laws unless the indictment is found or the information is instituted within three years of the commission of the offense.

Interest on refunds and judgments.—Section 1324 provides, with certain limitations, for the payment of interest by the government on refunds and judgments.[60]

Unnecessary examinations.—Section 1309[61] of the 1921

[58] See page 291.
[59] See page 262.
[60] See page 300.
[61] See page 211.

law provides that only one inspection of the taxpayer's books of account shall be made for each taxable year, unless the taxpayer requests otherwise, or unless the Commissioner, after investigation, notifies the taxpayer in writing that an additional investigation is necessary.

APPENDIX A

SUPPLEMENT TO EXCESS PROFITS TAX PROCEDURE, 1921

The material contained in this appendix consists solely of a discussion of the rulings or decisions made during 1922 which contain new features or which supersede former rulings. This new material together with that included in Appendix A of *Income Tax Procedure, 1922*, will bring *Excess Profits Tax Procedure, 1921*, up to date. This appendix is divided into chapters corresponding to those of the 1921 book, and all comments and rulings are preceded by a reference to a page of the 1921 book. By this means the reader will be able readily to relate the latest rulings to the corresponding matter in his copy of *Excess Profits Tax Procedure, 1921*.

CHAPTER V

COMPUTATION AND RATES OF THE TAX

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Returns for period of less than twelve months.—The following ruling supports the allowance of the full $3,000 credit under section 302, allowing for the prorated income tax credit of $2,000.[1]

RULING. A taxpayer made a return for seven months under the Revenue Act of 1921, which disclosed an actual net income of less than $25,000. The question was submitted as to the proper method of computing the income and excess profits taxes of the taxpayer when section 302 of that Act is applied in determining the excess-profits tax.

Held, that in order for a corporation whose return covers a period of less than one year to have the full benefit of section 302, which allows an exemption of $3,000 in all cases irrespective of whether the return is for an entire year or only for a fractional part of a year, it is necessary to compute the excess-profits tax upon the actual amount of the income shown by the return, less $3,000. In computing the income tax, however, the credit of $2,000 must be reduced to such a proportion of the full credit as the number of months in the period for which the return is made bears to 12 months. This amount should be added to the amount of the excess-profits tax and the sum deducted from the net income shown by the return. The net income should then be placed on an annual basis and the income tax computed. The income tax should then be reduced to the basis of the period covered by the return and, when added to the excess-profits tax, will give the total liability of the corporation.

Held also, that although the taxpayer's net income when raised to an annual basis exceeded $25,000, that fact did not destroy its right to the proportionate part of the $2,000 credit in computing the income tax, as the right to such credit is determined by the actual amount of the net income shown by the return and not by the amount which is disclosed when the net income is placed on an annual basis.

Applying this method of computation to a fictitious case will give the following results:

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[1] See also Chapter XV.

Net income (without deductions for credits)		$19,190.51
Exemption		3,000.00
Amount subject to excess-profits tax		16,190.51
Excess-profits tax at 20 per cent (under sec. 302)		3,238.10
Net income		19,190.51
Profits tax	$3,238.10	
Proportionate part of $2,000	1,116.67	4,354.77
Balance subject to income tax		14,835.74
Balance raised to annual basis		25,432.70
Income tax on annual basis		2,543.27
Income tax reduced to basis of return		1,483.57
Add: Excess-profits tax		3,238.10
Total tax for the period		4,721.67

(I-36-493; I. T. 1439.)

CHAPTER VI

CREDITS AND SPECIFIC EXEMPTIONS

[Former Procedure] **Page 120**

"Average deduction" of representative corporations.—A taxpayer whose pre-war operations were greatly curtailed claimed the benefit of section 205 of the 1917 law. The taxpayer contended that the deduction to be applied in its case should be based on the average of the percentages of earnings of representative corporations rather than on the average of the deductions allowed such corporations. The Committee properly held that:

Ruling. The term "average deduction" as used in section 205 of the Revenue Act of 1917 means the average of the deductions allowed to representative concerns after the limitations provided in section 203 of the same Act have been applied. (C. B. I-1, page 336; Digest A. R. R. 716.)

Corporation in existence in pre-war period.—The Treasury has held (I-37-506; A. R. M. 174) that a corporation

incorporated in 1912 but which did not commence business until May 1, 1913, was in existence during the whole of the pre-war calendar year 1913, and therefore is not entitled to a deduction computed under section 204 of the Revenue Act of 1917.

CHAPTER VII

INVESTED CAPITAL IN GENERAL—BORROWED MONEY

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When borrowed money included in invested capital.—

Ruling. The terms "current liabilities" and "temporary indebtedness" as used in article 44 of Regulations 41 are intended to apply to liabilities chargeable against profits as distinguished from indebtedness incurred for the purpose of raising capital.

In case a corporation has no permanent indebtedness but the amount of deductible interest was limited, no amount may be included in invested capital on account of such limitation, but where the corporation has both temporary and permanent indebtedness, it may assume, to the extent of its permanent indebtedness, that any interest which it is not allowed to deduct has been paid upon such permanent indebtedness.

The term permanent indebtedness covers money and property borrowed to be invested in the business. In case the permanent indebtedness is increased, diminished, or liquidated during the tax period, the average amount of such indebtedness for the period should be used in applying the provisions of article 44, Regulations 41, supra. (C. B. I-1, page 346; Digest I. T. 1226.)

It was important for purposes of 1917 invested capital that corporations having a large floating debt and relatively small capital stock be permitted the benefit of article 44 of Regulations 41, as the principle involved in such a case is not a whit different from that applying to the case of a corporation with a very large indebtedness evidenced by long-term bonds.

The following sentences from the detailed ruling,

> If the indebtedness is of a permanent character the term or nature of the particular obligation by which the indebtedness is evidenced at any time is not conclusive. Thus, notes used to acquire borrowed capital which the corporation plans to continue to use after the maturity of the notes (meeting the matured notes with the proceeds of other borrowings) may be regarded as permanent indebtedness within the meaning of article 44 of Regulations 41.

and the distinction contained in the first paragraph of the foregoing digest of ruling I. T. 1226, would appear to warrant treating notes payable for money borrowed as being "permanent indebtedness" for 1917 excess profits tax purposes in practically all cases. Accounts payable for purchases of merchandise or for current expenses would be "liabilities chargeable against profits." Notes payable for money borrowed or given for plant additions are "indebtedness incurred for the purpose of raising capital." In the case of notes payable given to merchandise creditors, it might seem at first glance as though such notes were not "indebtedness incurred for the purpose of raising capital." In fact, however, they would be given in liquidation of an indebtedness incurred on open account and by thus issuing an interest-bearing obligation instead of making payment forthwith, there has been in effect a raising of capital.

It may be further pointed out that there is no provision in the 1917 law which warrants the Treasury in making any distinction between classes of interest-bearing indebtedness and giving one class the benefit of article 44 of Regulations 41 and denying it to another. The regulation was obviously enacted for the purpose of granting relief through the computation of invested capital corresponding approximately to the hardship sustained by the exclusion from the computation of taxable income of a portion of the interest paid. If it is permissible for the Treasury to grant such relief by regulation—and it was a highly necessary measure of relief—the relief must be granted uniformly. Unless revoked or held to

be illegal, the regulation has the same effect as the law itself. The hardship sustained by the taxpayer was just as great when the non-deductible interest was paid on current interest-bearing notes or acceptances for merchandise, as when the non-deductible interest was paid on long-term bonds. The mere incident as to the term or origin of the indebtedness is not important. The vital point is that interest was not fully deductible in determining taxable income and the effect of the Treasury regulation is to deem a corresponding amount of indebtedness to be invested capital and not borrowed capital because the interest paid thereon is not deductible. The regulation, therefore, must be applied uniformly to all cases where such a condition existed in 1917.

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Stock on instalment plan not invested capital.—In a case where stock was sold under an instalment contract, the stock certificates not being issued until full payment was made, the Treasury holds that the instalments represented borrowed money and as such could not be included in invested capital until authority to issue the stock was received.[2]

This case differs from O. D. 991[3] in that no statutory authority to issue the certificates was obtained until the stock was fully paid.

General speaking, the law did not contemplate that any borrowed money should be included in invested capital. In that respect the foregoing ruling is sound. But it is questionable if it was borrowed money. As stated in the ruling, "the subscription contract does not contemplate a repayment of the money paid by the subscriber." It would seem that a perpetual loan without interest to a corporation pro rata paid in by its stockholders *would* be capital within the meaning of the law.

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[2] (C. B. I-1, page 341; I. T. 1334.)
[3] See page 872, and *Income Tax Procedure, 1922*, page 1616.

CHAPTER VIII

INVESTED CAPITAL—ADJUSTMENT OF ASSET VALUES

Page 152

Paid-in surplus.—

Ruling. . . . . In the opinion of the Committee, the facts in this case show conclusively that the M Company was organized with 120*x* dollars cash paid in, 57½ per cent of which was supplied by outside interests, and that 60*x* dollars of this cash was paid to the N Company for the assets of the latter. It is further shown that only approximately 20 per cent of the stockholders in the N Company became stockholders in the M Company. It seems fallacious, therefore, to argue that the assets of the N Company were paid in to the M Company for stock of the latter when 80 per cent of the stockholders received none of this stock. For the same reason the argument that the N Company or the stockholders thereof contributed to the M Company value which was not paid for appears to be equally untenable. All of this only emphasizes the soundness of the provision of article 836, Regulations 45, which lays down the rule that:

> Generally, allowable claims under this article will arise out of transactions in which there has been no substantial change of beneficial interest in the property paid in to the corporation and in all cases the proof of value must be clear and explicit.

The Committee is therefore forced to the conclusion that the action of the Unit in rejecting this claim for paid-in surplus was correct and should be sustained. . . . . (I-27-386; A. R. R. 944.)

It was not shown that the old stockholders who did not subscribe relinquished their rights with a knowledge of the value subsequently claimed as paid-in surplus.

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Evidence to support claim for paid-in surplus.—Article 836 of Regulations 45 and 62 has been amended as follows:

Regulation. The paid-in surplus allowed in any case is confined to the value definitely known or accurately ascertainable at the time the property is paid in. Evidence offered to support a claim for a paid-in surplus must be as of the date of the payment. It may consist among other things of (*a*) an appraisal of the property by disinterested authorities, (*b*) a certificate of the assessed value in the case of real estate, or (*c*) evidence of a market price in excess of the

par value of the stock or shares. Opinion evidence, expert or otherwise, of the value of property as of a prior date will not be accepted. Retrospective appraisals submitted in support of a claim for a paid-in surplus will not be accepted in any case where other reasonably satisfactory evidence is available and in any case will be accepted only after rigid scrutiny and will be followed only to the extent to which their reasonableness is fully established. The property which was paid in is the basis of the appraisal, and the appraisal must reconcile the accounts so as to reflect accurately the actual value on the date as of which the appraisal is made and the depreciation sustained. Proper consideration must in all cases be given to depreciation and the expired and remaining serviceable life of the property must be shown. To be acceptable retrospective appraisals must show: (1) The history of the business and manner in which the information or data was acquired; (2) the manner in which the appraisals were constructed; (3) the inventory on the date of the appraisal in detail; (4) the date of acquisition of all items remaining in the inventory as of the date of appraisal; (5) the elimination from the inventory of all items acquired subsequent to the date as of which the appraisal is made and how this was effected (all items, the date of acquisition of which can not be definitely determined, should be listed separately and all the facts bearing upon the date of acquisition given); (6) the replacement cost at the date as of which the appraisal is made of each item accepted as on hand on that date determined upon competent data, with a statement of the method employed in arriving at such cost (estimates and general statements will not be accepted); (7) the rate and total amount of depreciation as shown by the books; (8) the rate and total amount of depreciation taken upon each item included in the appraisal for the purposes of the appraisal (if other than normal rates of depreciation are used the reason therefor and the method of computing depreciation must be fully explained); (9) the actual cost when ascertainable of each item included in the appraisal; (10) the book value on the date as of which the appraisal is made of all the items included in the appraisal; and (11) a detailed statement of all plant facilities and additions, represented by capital expenditures previously written off, which were still in use on the date as of which the appraisal was made and all the depreciation actually sustained or accrued on such items. No claim will be allowed for paid-in surplus in any case in which the addition of value has been developed or ascertained subsequent to the date on which the property was paid in to the corporation, or in respect of property which the stockholders or their agents on or shortly before the date of such payment acquired at a bargain price, as for instance, at a receiver's sale. Generally, allowable claims under this article will arise out of transactions in which there has been no substantial change of beneficial interest in the property paid in to the corporation and in all cases the proof of

value must be clear and explicit. (Art. 836, as amended by T. D. 3367, dated July 10, 1922.)

The amended article defines the Treasury's attitude towards retrospective appraisals,[4] and lists the data necessary to support claims for paid-in surplus based on such appraisals. The evidence of experts as to value is apparently not acceptable to the Treasury. However, in any disputed cases, taxpayers may rest assured that the testimony of expert witnesses will be given proper weight in the courts.

Page 154

Water power as tangible property.—

Ruling. Where water-power is developed and applied on the same parcel of land by virtue of riparian rights of the owner of the land, its value is an element of the value of the land and should be treated as a tangible property for the purpose of determining invested capital.

Where a number of small dams at a given point are acquired by a corporation and consolidated as one dam, the proper measure of value of the property thus acquired, for the purpose of determining invested capital, is the total value of all the powers thus acquired, valued separately.

Where water power is valued at a certain amount per horsepower, the valuation in such cases should relate to horsepower actually developed at the date of valuation and not to the estimated potential power. (C. B. I-1, page 360; Sol. Op. 129.)

Page 156

Original cost of tangible property disallowed in reorganization.—

Ruling. The tangible and intangible assets of the R Company which was dissolved and an affiliated company, the N corporation, whose affairs were turned over to a bondholders' committee, were transferred to the M corporation upon its organization prior to March 3, 1917, for stock in the M Company. The total value of the tangible assets paid in for stock was less than the par value of the stock issued and therefore a claim for paid-in surplus, based upon the original cost of the assets to the original companies, can not be allowed.

[4] See also C. B. I-1, page 353; A. R. R. 747; quoted in *Income Tax Procedure,* 1922, page 1589 *et seq.*

The identity of the stockholders of these corporations does not destroy their separate entities nor constitute one a continuation of the others and entitled to the same invested capital. (C. B. I-1, page 365; Digest A. R. R. 761.)

The foregoing ruling rests on the separate identities of the old and new companies. The stockholders were the same and it is not clear why the full cost of the tangible assets was not allowed as invested capital. The computation of invested capital is highly technical and is not affected by the court decisions cited in the ruling, since the decisions do not deal with invested capital. The *La Belle Iron Works Co.*[5] decision is the one which controls. The actual investment of the present taxpayer is the criterion. A reorganization before March 3, 1917 calls for an extension—not a limitation—of the measure of invested capital.

No paid-in surplus when assets acquired from minority stockholders.—

Ruling. Where the members of a partnership upon incorporation transferred their lease to certain property in return for stock and thereby became minority stockholders of the corporation, the transaction should be treated as an ordinary case of sale and purchase between a vendor and a vendee, and if the corporation after date of purchase discovers the lease was purchased by it at a bargain price, it can not include the alleged excess of the value of the lease over the consideration given for the same as paid-in surplus in computing its invested capital. (C. B. I-1, page 365; Digest I. T. 1285.)

Page 169

Notes received for capital stock.—

Ruling. Section 8632 of the Ohio General Code, which provides that at the time of making a subscription 10 per cent on each share subscribed for shall be paid, and which provides that the residue shall be paid in such installments at the times and places and to such persons as the directors require, has been construed by the Ohio courts as merely marking the time when the first installment shall be payable upon a stock subscription and as providing the mode for determining the time at which the residue shall become payable. (*Cham-*

[5] *La Belle Iron Works v. U. S.*, 256 U. S. 377, 41 Sup. Ct. 528, 65 L. Ed. 998.

berlain v. Railroad, 15 Ohio State, 249.) Stock issued without the payment of the first 10 per cent at the time of making the subscription is not invalid. (*Smith v. Railroad,* 15 Ohio State, 336, and *Henry v. Railroad,* 13 Ohio Reports, 187.) A note given for such 10 per cent is enforceable. (*Latham v. Insurance Co.,* 1 Bull., 127.)

In view of the above interpretation, it is held that, under the provisions of section 8632 of the Ohio General Code, promissory notes of subscribers may legally be received in respect of the entire amount of stock subscribed. Consequently, it follows that all the notes received by the M Company upon stock subscriptions may be included in the company's invested capital to the extent of their fair market value at the time paid in under the provisions of article 833 of Regulations 45, provided they were received in absolute payment and not as conditional payment only. (I-31-444; I. T. 1409.)

Page 173

Restoration of installation costs.—

RULING. If a corporation employed its own labor in the construction of its plant, such as building of machine foundations and in the installation and assembling of machines and other equipment, the value of the labor so employed represented a capital expenditure which may be included in invested capital. If the value of such labor was deducted as an expense in excise and income tax returns for years prior to 1917, it may be restored to invested capital at its depreciated value provided amended returns are filed for each year during which a deduction from income was made, in which returns the amended net income shall be increased by the value of the labor previously deducted as an expense. (C. B. I-1, page 370; Digest I. T. 1347.)

CHAPTER X

ADJUSTMENT OF CAPITAL, SURPLUS, RESERVES AND LIABILITIES

Page 226

Capital stock paid for in instalments.—In a case where instalments of capital stock subscriptions were received by a corporation prior to obtaining a certificate of increase from the secretary of state, it was held that such instalments con-

stituted borrowed money and could not be included in invested capital.[6]

Page 233

Reserves for bad debts.—A recent ruling (I-49-629; I. T. 1524) confirms the author's opinion that the reserve for bad debts at December 31, 1920, is included in invested capital at January 1, 1921. (*Income Tax Procedure,* 1922, page 1616.) The ruling, however, holds that any part of the reserve utilized in 1921 "to liquidate debts outstanding on December 31, 1920, subsequently determined to be worthless" is subject to "proper adjustment during the year." From the foregoing it must be inferred that if a reserve of $1,000 for bad debts is used in 1921, it would decrease invested capital on the date of ascertaining a debt to be bad or on the date of charging off the debt. The obvious treatment was to adjust the reserve on December 31, 1921, which would not have the effect of decreasing invested capital at all.

As bad debts ascertained to be bad in 1921 were chargeable against income in 1921, it is not clear how invested capital could also be decreased.

Page 242

Decrease in invested capital by payment of federal taxes.—The author wishes to repeat what has been said previously on this point:

Earned surplus is specifically included in invested capital. By this is meant the assets representing the surplus rather than the surplus account. The principle of the law is that every dollar of earnings shall have the benefit of a credit before any excess profits tax shall be assessed. The credit is measured by the invested capital. If there is no invested capital, thus yielding no credit, the full rates of tax cannot be applied. Relief is granted. Assume that in 1922 a cor-

[6] C. B. I-1, page 341; I. T. 1334. This ruling limits O. D. 991, quoted in *Income Tax Procedure,* 1922, page 1616. See also page 872.

poration receives notice of a proposed additional assessment of $10,000 arising from alleged errors in its 1918 return. The Treasury immediately reduces earned surplus by the same amount. Under no circumstances can it be held that the earned surplus *was* reduced in the year 1919, because there was no reduction in any of its assets during that year. The cash account was not reduced. Any earnings from the $10,000 were entitled to a credit for the assets which produced the earnings. Reducing earned surplus by $10,000 would subject part of the earnings to tax with no credit for any invested capital. Unlike an after-discovered liability due in 1918, the proposed additional tax is not due until assessed. The theory that the government should have had the cash in 1919 is not pertinent. The law regarding invested capital is highly technical. A vast amount of legitimate capital has been excluded purely on technical grounds. The law prescribes specific penalties and interest penalties for taxes not paid when due. The Treasury cannot add additional penalties. The $10,000 item was unknown on December 31, 1918. It is disputed in 1922. The Treasury cannot apply it retroactively to a date when it was bona fide unknown; when it was not due; when earned surplus and the assets were not in fact reduced by it.

Taxpayers whose invested capital for prior years has been reduced in this manner should take steps to protect their interests in case the Treasury ruling is reversed.

Decrease in invested capital of certain fiscal year corporations by payment of federal taxes under 1921 law.—

RULING. Advice has been requested as to the effect of Treasury Decision 3310[7] (Bulletin I-15-214, p. 11) on the invested capital of corporations subject to its provisions.

A case is cited of a corporation whose fiscal year ended June 30, 1921, and which is subject to additional tax under the Revenue Act

[7] Refers to fiscal year corporations which had filed returns prior to November 23, 1921 and were subject to additional tax under 1921 law. See page 174, footnote 19.

of 1921. Information is desired as to whether this tax, which is payable in four installments commencing with May 15, 1922, has any effect upon the invested capital of the corporation for the fiscal year beginning July 1, 1921.

The tax due on the new return is not to be considered as an additional tax due under the Revenue Act of 1918, with reference to its effect upon invested capital, inasmuch as it is an original tax due under the Revenue Act of 1921, and as such has the effect of reducing the invested capital of the corporation for the fiscal year beginning in 1921 to the extent that it is due and payable during such taxable year. A deduction from invested capital as of the beginning of such taxable year must therefore be made for the installments of such tax becoming due and payable within the taxable year averaged in the usual manner. (I-30-432; I. T. 1400.)

The above ruling recognizes the fact that invested capital should not be decreased until the cash actually goes out of the business. The same principle should be applied to additional assessments of taxes for prior years.[8]

CHAPTER XI

CHANGES IN INVESTED CAPITAL

Page 263

Decrease in invested capital through dividends.—The phrase "shall be deemed" in section 201 (e) of the 1918 law [section 201 (f) of the 1921 law] relating to dividends paid during the first 60 days of the taxable year, does not admit of rebuttal and is conclusive that such dividends were paid from surplus accumulated during preceding taxable years.[9]

In a case where a corporation discontinued its business, sold its plant, went into liquidation and paid a dividend, partly from the profits on the sale of its plant, it was held that such

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[8] See *Excess Profits Tax Procedure,* 1921, page 242 *et seq.,* and *Income Tax Procedure,* 1922, page 1619.

[9] C. B. I-1, page 12; Sol. Op. 140. See also discussion of this phrase in *Harder v. Irwin,* U. S. Dist. Ct., Nor. Dist. N. Y., Nov. 29, 1922.

dividend is presumed conclusively to have been paid out of earnings accumulated between March 1, 1913, and the beginning of the taxable year previous to the payment of the dividend, so far as such earnings are sufficient and to the extent that such earnings are insufficient, the dividend will be deemed to have been paid out of earnings of the current year. If the dividend is greater than the total of such earnings, the excess will be deemed to have been paid out of earned surplus accumulated prior to March 1, 1913, or to be a liquidation of paid-in surplus or capital.[10]

The payment of taxes by a bank on behalf of its shareholders will be treated under the Revenue Act of 1918[11] as far as invested capital is concerned, as a dividend.[12]

The distribution among the stockholders of the stock of a foreign subsidiary reduces the invested capital of the parent company in exactly the same way as any other distribution.[13]

CHAPTER XII

PRE-WAR INVESTED CAPITAL

Page 276

Pre-war invested capital when certain branches since abandoned.—

Ruling. In determining the war profits credit under the Revenue Act of 1918, income and invested capital attributable to certain abandoned branches or departments of a business conducted during the prewar period may not be segregated and eliminated from prewar data. (I-30-433; Digest A. R. R. 979.)

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[10] C. B. I-1, page 373; I. T. 1375.

[11] Under the Revenue Act of 1921, banks or other corporations paying taxes assessed against their stockholders on account of their ownership of the shares of stock issued by such corporations, without reimbursement from such shareholder or member, may deduct the amount of taxes so paid. (Art. 566.)

[12] C. B. I-1, page 372; I. T. 1279.

[13] C. B. I-1, page 373; I. T. 1314.

CHAPTER XIV

CONSOLIDATED RETURNS OF AFFILIATED CORPORATIONS

Page 304 et seq.

The question of consolidated returns has now an interest merely from an income tax standpoint. For that reason a chapter ("Returns—Affiliated Corporations," Chapter VI) has been included in the body of this book dealing with the conditions for affiliation and the procedure to be followed in making consolidated returns. The new rulings on this subject issued during 1922 are included therein.

Sales from one affiliated corporation to another.—Revenue agents in some cases have recommended that transactions between affiliated corporations prior to 1917, when the property sold was valued at a price higher than cost, be adjusted to the original cost to the vendor. There is nothing in the law or the regulations to justify this practice. Prior to 1917, consolidated returns were not permitted. Profits arising from transactions between affiliated concerns were fully taxable. The property received by the purchaser may be included in invested capital at its cost. The Supreme Court in the *LaBelle Iron Works Co.* case disallowed appreciation but made it clear that a taxpayer's full investment could be included. A purchase at a price less than cost to the seller would not justify the purchaser in appreciating the book cost of the property purchased, even though it was acquired from an affiliated corporation. Any bona fide transaction between separate entities prior to 1917 must be conclusive.

Intercompany profits in consolidated balance sheets at January 1, 1917.—In computing invested capital the Treasury has reduced inventory values and correspondingly reduced earned surplus by the amount of the intercompany profits which appears in consolidated balance sheets at January 1,

1917. The adjustment likewise increases net income for the year 1917. The adjustment is proper from the standpoint of good accounting practice but illegal and erroneous under the Revenue Acts of 1916 and 1917. Under the former, corporate entities were separate. The sale of goods from one corporation to another was a closed and taxable transaction even though one corporation owned all of the stock of another. Therefore intercompany profits prior to January 1, 1917, were tax-paid and completed transactions. The computation of invested capital at January 1, 1917, in the case of consolidated returns rests on the highly technical make-up of the investment accounts of the several entities and not on good accounting practice.

CHAPTER XV

THE RELIEF SECTIONS

Page 340

"Abnormal conditions."—The author discussed fully what constituted "abnormal conditions," entitling a taxpayer to relief, in *Excess Profits Tax Procedure,* 1921, page 340 *et seq.* During 1922, the Solicitor has defined "abnormal conditions" in two rulings.

Early in 1922 the Solicitor rendered an opinion which should have been the final word of the Treasury in defining its position regarding relief cases.[14] As the opinion requires eight pages of the official bulletin it is not feasible to reproduce it in full. In dealing with representative corporations the Solicitor approved the use of four comparatives which had high earnings and disapproved two comparatives which had low earnings. The Solicitor said:

> .... The word "representative," as used in the Act, means "typical" or "symbolical," and the Act requires the comparatives used to be typical as near as may be in respect to capital employed, gross in-

[14] C. B. I-1, pages 383-391; L. O. 1090.

come, profits per unit of business transacted, amount and rate of war and excess profits tax, and all other relevant facts and circumstances. The corporations used as comparatives must not only be in the same general line of business, but as nearly as possible representative in all the particulars mentioned in the Act. . . . .

On November 20, 1922, L. O. 1090 was revoked.[15] The recent decision will govern unless and until it is revoked, so it is reproduced in full:

RULING. Due to the difficulty which has been experienced in interpreting and applying Law Opinion 1090, it appears advisable to reconsider that opinion. Furthermore, it is necessary to give further consideration to the question of what constitutes proper comparatives for the M Company, the case which was under consideration in Law Opinion 1090.

The facts in the case of the M Company are as follows:

The M Company appears to have begun business about 1901 and to have organized under its present name in 1905, with a cash capital of 60*x* dollars. In 1909 it took over the assets of the O Company and the P Company and increased its capital stock to 600*x* dollars. Under the reorganization, 15¾*y* shares of stock of the par value of $100 were issued for tangible assets, and 14¼*y* shares of the same par value for intangible assets. Until 1916 the corporation's earnings were small, and it was its policy to reinvest its earnings and surplus in plant property. Since 1917 the company's earnings have been very large, due, no doubt, in a large part to war conditions. In 1918, its statutory invested capital was over 1200*x* dollars and its net income approximately 700*x* dollars.

The company has made claim for the abatement of 71.3*x* dollars excess-profits taxes for the year 1918, the claim being based upon an application for assessment under sections 327 and 328 of the Revenue Act of 1918. The Income Tax Unit allowed relief under the above sections and computed the tax by means of comparatives under section 328, and found the corporation entitled to an abatement in the sum of 71.3*x* dollars and a refund in the amount of 40*x* dollars.

The claim of the taxpayer for assessment under sections 327 and 328 is based on the fact that it has spent large sums in experimental work and that as a result thereof it has developed secret formulas which give it a practical monopoly in the manufacture of certain types of high-grade ———; that none of the amounts spent in experimental and discovery work has been capitalized; that it now has valuable intangible property which is not reflected in its invested capital, and that by reason thereof it is subject to an exceptional hardship when

[15] I-47-606; L. O. 1109.

compared with other corporations in its class which have capitalized such expenditures.

The question presented is whether the M Company is entitled to relief under the provisions of sections 327 and 328, and if so, whether the comparatives used in computing the tax under section 328 are proper.

The pertinent provisions of the Revenue Act of 1918 follow: (sections 327 and 328 are quoted by the Solicitor.)

While it is manifestly impossible to enumerate all the classes of cases in which there exists an abnormality affecting the capital or income of a corporation which may entitle the corporation to assessment under section 328, it is thought advisable to set out some of the more usual conditions or circumstances which result in such an abnormality as may form the basis for assessment under that section. The following enumeration is by no means an exclusive one; no attempt is made to enumerate all the conditions or circumstances which result in an abnormality under the statute. However, a statement of the typical and usual cases in which an abnormality exists affecting income or capital is of value in that it shows the type of cases contemplated by the statute and answers some of the questions which most often arise regarding the construction and application of the section of the statute. It should be borne in mind, however, in determining in a specific case whether there exists such an abnomality as to entitle the corporation to assessment under section 328, that sections 327 and 328 are obviously relief sections and should be construed and applied so as to carry into effect the clear intention of Congress.

It is my opinion that the following represent the typical and common cases in which there is present an abnormal condition affecting capital or income of a corporation: (1) Where a corporation is placed in a position of substantial inequality because of the time or manner of organization; (2) where the capital employed, although a material income-producing factor, is very small or is in a large part borrowed; (3) where there are excluded from invested capital computed under section 326 intangible assets, of recognized value and substantial in amount, built up or developed by the taxpayer; (4) where the net income for the year is abnormally high, due to the realization in one year of (*a*) income earned during a period of years, or (*b*) extraordinary profit derived from the sale of property the principal value of which has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, or (*c*) gain derived in one year from the sale of property the increase in value of which had accrued over a period of years; and (5) where proper recognition or allowance cannot be made for amortization, obsolescence, or exceptional depletion due to the World War.

The above alone, however, is not sufficient to entitle the taxpayer to the benefit of assessment under section 328. The circumstances outlined above must work upon the corporation an exceptional hardship, evidenced by gross disproportion between the tax computed without the benefit of sections 327 and 328 and the tax computed under section 328, in order that the taxpayer may be entitled to special relief. "Exceptional hardship," which is a prerequisite to assessment under section 328, must be evidenced by *gross disproportion* between the tax computed without the benefit of the relief sections and the tax computed under section 328 by a comparison with representative corporations engaged in a like or similar trade or business and similarly circumstanced with the taxpayer as nearly as may be with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

In determining whether a taxpayer is entitled to assessment under section 328 because of any of the reasons given above, the limitation contained in section 327 (d) should be constantly borne in mind. A taxpayer is not entitled to relief if its tax is high merely because it earned within the taxable year a high rate of profit upon a normal invested capital. The distinction between those cases in which the tax, computed without benefit of the relief provision, is exceptionally high because of abnormal conditions affecting invested capital or net income and those cases in which the tax is high merely because the corporation earned exceptionally high profits upon a normal invested capital, is an important one; in the first case, the corporation may be entitled to relief; in the second case, it is not entitled to relief.

Applying the above to the instant case, it is my opinion that the M Company is entitled to assessment under the provisions of section 328, since the tax, if determined without the benefit of the relief section, would, owing to the existence of an abnormal condition affecting the capital of the company, work upon the company an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of the relief sections and the tax computed by reference to the representative corporations specified in section 328.

Under sections 327 and 328, where an abnormality exists affecting the net income or invested capital of the corporation, so that the corporation is entitled to special relief, the rate of tax of the corporation shall be based upon the average rate of tax of representative corporations engaged in a like or similar trade or business and similarly circumstanced as nearly as may be with the taxpayer. Representative corporations, within the meaning of this section, are the typical or average ones in that trade or business, as distinguished from the ones having peculiar characteristics. The intent of the section, therefore, is that the rate of tax of a corporation entitled to special relief shall be based upon the average rate of tax of the typical

or average corporations in that trade or business which are similarly circumstanced, as nearly as may be, with the taxpayer. Great care should be exercised in the selection of these comparatives, because the granting of relief under section 328 and the comparison with other corporations which are either not representative of the trade or business or not similarly circumstanced in all particulars specified in the Act, may create inequalities rather than correct them.

However, it must be recognized as a practical matter that it is not always, and in fact is seldom, possible to find comparatives representative of the trade or business which are similarly circumstanced with the taxpayer in all particulars specified in the Act. In fact, the statute expressly recognizes this fact by providing that the corporations with which the taxpayer entitled to special relief is comparde must be similarly circumstanced *"as nearly as may be"* with respect to the various facts and circumstances specified.

These six comparatives given on the data sheet, I am advised, comprise the corporations representative of the same trade or business as the M Company, which are most similarly circumstanced with respect to the items specified in section 328, with the taxpayer. It may be noted, however, that none of these six corporations is in exactly the same position as the taxpayer. The invested capital of comparatives 1 and 2 is approximately four times as large as the invested capital of the taxpayer; their gross income is nearly twice as large; their expense accounts do not compare favorably with that of the taxpayer. The amount of gross sales of comparative 6 is less than one-half that of the taxpayer. Its cost of goods sold is less than one-third that of the taxpayer, as is its expense account; its net income is considerably less than that of the taxpayer, while the proportion of its net income to gross sales is approximately twice that of the taxpayer. Furthermore, comparatives 3, 4, and 5, as may be seen, are circumstanced in many respects quite differently from the taxpayer. Thus, none of the six comparatives which are most nearly similarly circumstanced with the taxpayer is ideal. Nevertheless, the taxpayer is entitled to relief under section 328, and corporations must be used as comparatives which are similarly circumstanced as nearly as may be with the taxpayer. The six corporations used as comparatives in this case are those, I am advised, most similarly circumstanced with the taxpayer with respect to the items specified in section 328. Furthermore, the items of some which are dissimilar to the taxpayer are balanced by the corresponding items of the other comparatives, and the correctness of the result reached by the use of these comparatives is shown by the fact that the average obtained by grouping the six comparatives compares very closely with the taxpayer.

In the instant case the comparatives used are the ones most comparable to the taxpayer with respect to the items specified in section 328 and the average of these comparatives compares in every respect

favorably with the taxpayer. It is my opinion, therefore, that the comparatives used in the data sheet prepared in this case comply with the provisions of section 328.

Law Opinion 1090 is hereby revoked. (I-47-606; L. O. 1109.)

The Solicitor admits in the later opinion that comparatives need only be circumstanced *"as nearly as may be,"* and that the four corporations referred to as 3 to 6 and originally approved as representatives, were in reality "circumstanced in many respects quite differently from the taxpayer." Therefore comparatives 3 to 6 would have to be eliminated as well as 1 and 2. As the taxpayer was clearly entitled to relief, the Solicitor was forced to accept all comparatives as nearly circumstanced as could be found even though they did not pay high taxes, and approved the use of all six comparatives.

Taxpayers should carefully examine the five typical or common cases which qualify a corporation to apply for relief. In view of the many conflicting rulings by the Solicitor, taxpayers are justified in asking for a reconsideration if relief has been denied. If relief has not been asked for, application should be made prior to April 1, 1923, accompanied by formal claim for refund.

Page 355

Income from "cost-plus" contract.—The Solicitor has given the following definition of cost-plus contract:

Ruling. . . . . In my opinion "income derived on a cost-plus basis from a Government contract" means simply income derived from such a contract wherein the method of compensating the contractor is by way of reimbursing him the total actual cost of the work done or the article furnished and the payment to such contractor in addition thereto of a guaranteed profit, consisting either of (1) a fixed percentage of total cost, (2) a fixed profit of a definite sum agreed upon at the time of the closing of the contract, or (3) such fixed profit of a definite sum plus a percentage of any so-called saving effected by the contractor by the doing of such work or the production of such article at a cost below an agreed estimated cost of production fixed at the time of the closing of the contract. In common usage the term "cost-plus basis" has been used merely as a means of distinction from

the term "lump-sum basis," which is a method of compensation whereby the parties agree that the contractor will do certain work at an agreed total cost to the owner of a lump or fixed sum fixed at the time of the closing of the contract. See Kester, "Accounting, Theory and Practice," volume 3, pages 318 and 319. . . . . (C. B. I-1, page 391; A. R. R. 845.)

CHAPTER XVII

REORGANIZATIONS

Page 385

Change of domicile alone not a reorganization.—The Treasury has again ruled[16] that a mere change in domicile and charter without any accompanying change in business, capitalization, surplus or stock ownership, does not constitute a reorganization within the terms of section 331.

Page 386

Change of name with increase of capital stock does not change identity.—

Ruling. In 1885 certain persons organized a corporation and a certificate of incorporation was issued to them. In 1911, in pursuance of the advice of an attorney, the company was reorganized in order to cure defects in its original organization, and the powers of the corporation were broadened, its capital increased, and its existence made perpetual. In 1914 the name of the corporation was changed and thereupon all of the assets standing in the then name of the corporation were transferred by a deed having a covenant of warranty to the corporation designated by its new corporate name.

Held, that the copy of the original charter of the corporation and of the renewed charter, and the other evidence submitted by the taxpayer, disclose that the amendment of its charter and the subsequent change in its name did not create a new corporation, nor cause any change in its existing corporate organization. The invested capital of the corporation, accordingly, must be computed in the same manner as though the invested capital of the corporation originally formed in 1885 was being determined. The values of the assets on hand at the beginning of 1917 and later years must be determined by their values

[16] C. B. I-1, page 397; A. R. R. 844.

at the time of their original acquisition, as limited and defined by the Revenue Acts applicable to the taxable years involved, and their values at the date of the amendment of the corporation's charter or at the date of its change of name cannot be considered for such purpose. (I-33-459; I. T. 1420.)

Page 388

New corporation formed when assets acquired from corporation whose charter had expired.—The sale of assets of a corporation whose charter had expired to a new corporation whose stockholders were the same as those of the old corporation constituted a reorganization and amended returns under T. D. 3220[17] were required.[18]

Page 390

Inclusion of intangibles in case of reorganization.—A recent decision (I-49-628; I. T. 1523) holds that "the reorganization of a corporation does not necessarily cause any decrease in its capital represented by patents or other intangibles."

The foregoing ruling would seem to overrule the so-called "mixed aggregate" rule. The effect of the rule was to treat intangibles acquired for cash before reorganization as if acquired for stock at the time of reorganization and possibly reduce their inclusion in invested capital from 100 per cent to 25 per cent. The ruling states that "the rule applicable to the original corporation will apply in determining the amount at which the intangible assets acquired by the new corporation may be included in its invested capital."

The ruling means that in a reorganization before March 3, 1917, the intangibles will be valued on at least as favorable a basis as if acquired thereafter. In other words, intangibles such as patents, brands, and trade-marks purchased for cash prior to reorganization do not lose their cash-paid identity in a reorganization. Thus the separate entity theory receives another blow!

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[17] See *Income Tax Procedure,* 1922, page 1605.
[18] I-29-417; A. R. R. 988.

APPENDIX B

REVENUE ACT OF 1921

APPENDIX B

REVENUE ACT OF 1921*

[PUBLIC—No. 98—67TH CONGRESS.]
[H. R. 8245.]

An Act To reduce and equalize taxation, to provide revenue, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I.—GENERAL DEFINITIONS.

SECTION 1. That this Act may be cited as the "Revenue Act of 1921."

SEC. 2. That when used in this Act—

(1) The term "person" includes partnerships and corporations, as well as individuals;

(2) The term "corporation" includes associations, joint-stock companies, and insurance companies;

(3) The term "domestic" when applied to a corporation or partnership means created or organized in the United States;

(4) The term "foreign" when applied to a corporation or partnership means created or organized outside the United States;

(5) The term "United States" when used in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia;

(6) The term "Secretary" means the Secretary of the Treasury;

(7) The term "Commissioner" means the Commissioner of Internal Revenue;

(8) The term "collector" means collector of internal revenue;

(9) The term "taxpayer" includes any person, trust or estate subject to a tax imposed by this Act;

(10) The term "military or naval forces of the United States" includes the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, and the Navy Nurse Corps, Female, but this shall not be deemed to exclude other units otherwise included within such terms; and

(11) The term "Government contract" means (a) a contract made with the United States, or with any department, bureau, officer, commission, board, or agency, under the United States and acting in its behalf, or with any agency controlled by any of the above if the contract is for the benefit of the United States, or (b) a subcontract made with a con-

*As amended by China Trade Act, 1922.

tractor performing such a contract if the products or services to be furnished under the subcontract are for the benefit of the United States. The term "Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive" when applied to a contract of the kind referred to in clause (a) of this subdivision, includes all such contracts which, although entered into during such period, were originally not enforceable, but which have been or may become enforceable by reason of subsequent validation in pursuance of law.

(12) A corporation organized under the China Trade Act, 1922, shall, for the purpose of this Act, be considered a domestic corporation.

TITLE II.—INCOME TAX.

PART I.—GENERAL PROVISIONS.

Definitions

SEC. 200. That when used in this title—

(1) The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under section 212 or section 232. The term "fiscal year" means an accounting period of twelve months ending on the last day of any month other than December. The first taxable year, to be called the taxable year 1921, shall be the calendar year 1921 [1918] or any fiscal year ending during the calendar year 1921;

(2) The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person, trust or estate;

(3) The term "withholding agent" means any person required to deduct and withhold any tax under the provisions of section 221 or section 237;

(4) The term "paid," for the purposes of the deductions and credits under this title, means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212; and

(5) The term "personal service corporation" means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits, or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

Dividends

Sec. 201 (a) That the term "dividend" when used in this title (except in paragraph (10) of subdivision (a) of section 234 and paragraph (4) of subdivision (a) of section 245) means any distribution made by a corporation to its shareholders or members, whether in cash or in other property, out of its earnings or profits accumulated since February 28, 1913, except a distribution made by a personal service corporation out of earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922.

(b) For the purposes of this Act every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913; but any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed. If any such tax-free distribution has been made the distributee shall not be allowed as a deduction from gross income any loss sustained from the sale or other disposition of his stock or shares unless, and then only to the extent that, the basis provided in section 202 exceeds the sum of (1) the amount realized from the sale or other disposition of such stock or shares, and (2) the aggregate amount of such distributions received by him thereon.

(c) Any distribution (whether in cash or other property) made by a corporation to its shareholders or members otherwise than out of (1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, shall be applied against and reduce the basis provided in section 202 for the purpose of ascertaining the gain derived or the loss sustained from the sale or other disposition of the stock or shares by the distributee.

(d) A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend to the extent of the earnings or profits accumulated by such corporation after February 28, 1913.

(e) For the purposes of this Act, a taxable distribution made by a corporation to its shareholders or members shall be included in the gross income of the distributees as of the date when the cash or other property is unqualifiedly made subject to their demands.

(f) Any distribution made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding

taxable year and the date of distribution, to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits, the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period. This subdivision shall not be in effect after December 31, 1921.

Basis for Determining Gain or Loss

SEC. 202. (a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that—

(1) In the case of such property, which should be included in the inventory, the basis shall be the last inventory value thereof;

(2) In the case of such property, acquired by gift after December 31, 1920, the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner. In the case of such property acquired by gift on or before December 31, 1920, the basis for ascertaining gain or loss from a sale or other disposition thereof shall be the fair market price or value of such property at the time of such acquisition;

(3) In the case of such property, acquired by bequest, devise, or inheritance, the basis shall be the fair market price or value of such property at the time of such acquisition. The provisions of this paragraph shall apply to the acquisition of such property interests as are specified in subdivision (c) or (e) of section 402.

(b) The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a); but—

(1) If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall be the excess of the amount realized therefor over such fair market price or value;

(2) If its fair market price or value as of March 1, 1913, is lower than such basis, the deductible loss is the excess of the fair market price or value as of March 1, 1913, over the amount realized therefor; and

(3) If the amount realized therefor is more than such basis but not more than its fair market price or value as of March 1, 1913, or less

than such basis but not less than such fair market price or value, no gain shall be included in and no loss deducted from the gross income.

(c) For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—

(1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use;

(2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected); or

(3) When (A) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For the purposes of this paragraph, a person is, or two or more persons are, "in control" of a corporation when owning at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

(d) (1) Where property is exchanged for other property and no gain or loss is recognized under the provisions of subdivision (c), the property received shall, for the purposes of this section, be treated as taking the place of the property exchanged therefor, except as provided in subdivision (e);

(2) Where property is compulsorily or involuntarily converted into cash or its equivalent in the manner described in paragraph (12) of subdivision (a) of section 214 and paragraph (14) of subdivision (a) of section 234, and the taxpayer proceeds in good faith to expend or set aside the proceeds of such conversion in the form and in the manner therein provided, the property acquired shall, for the purpose of this section, be treated as taking the place of a like proportion of the property converted.

(3) Where no deduction is allowed for a loss or a part thereof under the provisions of paragraph (5) of subdivision (a) of section 214 and

paragraph (4) of subdivision (a) of section 234, that part of the property acquired with relation to which such loss is disallowed shall for the purposes of this section be treated as taking the place of the property sold or disposed of.

(e) Where property is exchanged for other property which has no readily realizable market value, together with money or other property which has a readily realizable market value, then the money or the fair market value of the property having such readily realizable market value received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis, shall be taxable to the extent of the excess; but when property is exchanged for property specified in paragraphs (1), (2), and (3) of subdivision (c) as received in exchange, together with money or other property of a readily realizable market value other than that specified in such paragraphs, the money or the fair market value of such other property received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis shall be taxable to the extent of the excess.

(f) Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

Inventories

SEC. 203. That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Net Losses

SEC. 204. (a) That as used in this section the term "net loss" means only net losses resulting from the operation of any trade or business regularly carried on by the taxpayer (including losses sustained from the sale or other disposition of real estate, machinery, and other capital assets, used in the conduct of such trade or business); and when so resulting means the excess of the deductions allowed by section 214 or 234, as the case may be, over the sum of the following: (1) the gross income of the taxpayer for the taxable year, (2) the amount by which the interest received free from taxation under this title exceeds so much of the interest paid or accrued within the taxable year on indebtedness as is not permitted to be deducted by paragraph (2) of subdivision (a) of section 214 or by paragraph (2) of subdivision (a) of section 234, (3) the amount by which the deductible losses not sustained in such trade or business exceed the taxable gains or profits not derived from such trade or business, (4)

amounts received as dividends and allowed as a deduction under paragraph (6) of subdivision (a) of section 234, and (5) so much of the depletion deduction allowed with respect to any mine, oil or gas well as is based upon discovery value in lieu of cost.

(b) If for any taxable year beginning after December 31, 1920, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount thereof shall be deducted from the net income of the taxpayer for the succeeding taxable year; and if such net loss is in excess of the net income for such succeeding taxable year, the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year; the deduction in all cases to be made under regulations prescribed by the Commissioner with the approval of the Secretary.

(c) The benefit of this section shall be allowed to the members of a partnership and the beneficiaries of an estate or trust, and to insurance companies subject to the tax imposed by section 243 or 246, under regulations prescribed by the Commissioner with the approval of the Secretary.

(d) If it appears, upon the production of evidence satisfactory to the Commissioner, that a taxpayer having a fiscal year beginning in 1920 and ending in 1921 has sustained a net loss during such fiscal year, such taxpayer shall be entitled to the benefits of this section in respect to the same proportion of such net loss which the portion of such fiscal year falling within the calendar year 1921 is of the entire fiscal year.

FISCAL YEARS 1920-1921 AND 1921-1922.

SEC. 205. (a) That if a taxpayer makes return for a fiscal year beginning in 1920 and ending in 1921, his tax under this title for the taxable year 1921 shall be the sum of: (1) the same proportion of a tax for the entire period computed under Title II of the Revenue Act of 1918 at the rates for the calendar year 1920 which the portion of such period falling within the calendar year 1920 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates for the calendar year 1921, which the portion of such period falling within the calendar year 1921 is of the entire period.

Any amount paid before or after the passage of this Act on account of the tax imposed for such fiscal year by Title II of the Revenue Act of 1918 shall be credited toward the payment of the tax imposed for such fiscal year by this Act, and if the amount so paid exceeds the amount of such tax imposed by this Act, the excess shall be credited or refunded in accordance with the provisions of section 252.

(b) If a taxpayer makes return for a fiscal year beginning in 1921 and ending in 1922, his tax under this title for the taxable year 1922 shall be the sum of: (1) the same proportion of a tax for the entire period computed under this title (as in force on December 31, 1921) at the rates

for the calendar year 1921 which the portion of such period falling within the calendar year 1921 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title (as in force on January 1, 1922) at the rates for the calendar year 1922 which the portion of such period falling within the calendar year 1922, is of the entire period: *Provided,* That in the case of a personal service corporation the amount to be paid shall be only that specified in clause (2).

(c) If a fiscal year of a partnership begins in 1920 and ends in 1921, or begins in 1921 and ends in 1922, then (1) the rates for the calendar year during which such fiscal year begins shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such calendar year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year.

Capital Gain

SEC. 206. (a) That for the purpose of this title:

(1) The term "capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921;

(2) The term "capital loss" means deductible loss resulting from the sale or exchange of capital assets consummated after December 31, 1921;

(3) The term "capital deductions" means such deductions as are allowed under this title for the purpose of computing net income and are properly allocable to or chargeable against items of capital gain as defined in this section;

(4) The term "capital net gain" means the excess of the total amount of capital gain over the sum of the capital deductions and capital losses;

(5) The term "ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions; and

(6) The term "capital assets" as used in this section means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

(b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary

net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain; but if the taxpayer elects to be taxed under this section the total tax shall in no such case be less than 12½ per centum of the total net income. The total tax thus determined shall be computed, collected and paid in the same manner, at the same time and subject to the same provisions of law, including penalties, as other taxes under this title.

(c) In the case of a partnership or of an estate or trust, the proper part of each share of the net income which consists, respectively, of ordinary net income and capital net gain, shall be determined under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary, and shall be separately shown in the return of the partnership or estate or trust, and shall be taxed to the member or beneficiary or to the estate or trust as provided in sections 218 and 219, but at the rates and in the manner provided in subdivision (b) of this section.

PART II.—INDIVIDUALS.

Normal Tax

SEC. 210. That in lieu of the tax imposed by section 210 of the Revenue Act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 8 per centum of the amount of the net income in excess of the credits provided in section 216: *Provided*, That in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 4 per centum.

Surtax

SEC. 211. (a) That, in lieu of the tax imposed by section 211 of the Revenue Act of 1918, but in addition to the normal tax imposed by section 210 of this Act, there shall be levied, collected, and paid for each taxable year upon the net income of every individual—

(1) For the calendar year 1921, a surtax equal to the sum of the following:

1 per centum of the amount by which the net income exceeds $5,000 and does not exceed $6,000;

2 per centum of the amount by which the net income exceeds $6,000 and does not exceed $8,000;

3 per centum of the amount by which the net income exceeds $8,000 and does not exceed $10,000;

4 per centum of the amount by which the net income exceeds $10,000 and does not exceed $12,000;

5 per centum of the amount by which the net income exceeds $12,000 and does not exceed $14,000;

6 per centum of the amount by which the net income exceeds $14,000 and does not exceed $16,000;

7 per centum of the amount by which the net income exceeds $16,000 and does not exceed $18,000;

8 per centum of the amount by which the net income exceeds $18,000 and does not exceed $20,000;

9 per centum of the amount by which the net income exceeds $20,000 and does not exceed $22,000;

10 per centum of the amount by which the net income exceeds $22,000 and does not exceed $24,000;

11 per centum of the amount by which the net income exceeds $24,000 and does not exceed $26,000;

12 per centum of the amount by which the net income exceeds $26,000 and does not exceed $28,000;

13 per centum of the amount by which the net income exceeds $28,000 and does not exceed $30,000;

14 per centum of the amount by which the net income exceeds $30,000 but does not exceed $32,000;

15 per centum of the amount by which the net income exceeds $32,000 and does not exceed $34,000;

16 per centum of the amount by which the net income exceeds $34,000 and does not exceed $36,000;

17 per centum of the amount by which the net income exceeds $36,000 and does not exceed $38,000;

18 per centum of the amount by which the net income exceeds $38,000 and does not exceed $40,000;

19 per centum of the amount by which the net income exceeds $40,000 and does not exceed $42,000;

20 per centum of the amount by which the net income exceeds $42,000 and does not exceed $44,000;

21 per centum of the amount by which the net income exceeds $44,000 and does not exceed $46,000;

22 per centum of the amount by which the net income exceeds $46,000 and does not exceed $48,000;

23 per centum of the amount by which the net income exceeds $48,000 and does not exceed $50,000;

24 per centum of the amount by which the net income exceeds $50,000 and does not exceed $52,000;

25 per centum of the amount by which the net income exceeds $52,000 and does not exceed $54,000;

26 per centum of the amount by which the net income exceeds $54,000 and does not exceed $56,000;

27 per centum of the amount by which the net income exceeds $56,000 and does not exceed $58,000;

28 per centum of the amount by which the net income exceeds $58,000 and does not exceed $60,000;

29 per centum of the amount by which the net income exceeds $60,000 and does not exceed $62,000;

30 per centum of the amount by which the net income exceeds $62,000 and does not exceed $64,000;

31 per centum of the amount by which the net income exceeds $64,000 and does not exceed $66,000;

32 per centum of the amount by which the net income exceeds $66,000 and does not exceed $68,000;

33 per centum of the amount by which the net income exceeds $68,000 and does not exceed $70,000;

34 per centum of the amount by which the net income exceeds $70,000 and does not exceed $72,000;

35 per centum of the amount by which the net income exceeds $72,000 and does not exceed $74,000;

36 per centum of the amount by which the net income exceeds $74,000 and does not exceed $76,000;

37 per centum of the amount by which the net income exceeds $76,000 and does not exceed $78,000;

38 per centum of the amount by which the net income exceeds $78,000 and does not exceed $80,000;

39 per centum of the amount by which the net income exceeds $80,000 and does not exceed $82,000;

40 per centum of the amount by which the net income exceeds $82,000 and does not exceed $84,000;

41 per centum of the amount by which the net income exceeds $84,000 and does not exceed $86,000;

42 per centum of the amount by which the net income exceeds $86,000 and does not exceed $88,000;

43 per centum of the amount by which the net income exceeds $88,000 and does not exceed $90,000;

44 per centum of the amount by which the net income exceeds $90,000 and does not exceed $92,000;

45 per centum of the amount by which the net income exceeds $92,000 and does not exceed $94,000;

46 per centum of the amount by which the net income exceeds $94,000 and does not exceed $96,000;

47 per centum of the amount by which the net income exceeds $96,000 and does not exceed $98,000;

48 per centum of the amount by which the net income exceeds $98,000 and does not exceed $100,000;

52 per centum of the amount by which the net income exceeds $100,000 and does not exceed $150,000;

56 per centum of the amount by which the net income exceeds $150,000 and does not exceed $200,000;

60 per centum of the amount by which the net income exceeds $200,000 and does not exceed $300,000;

63 per centum of the amount by which the net income exceeds $300,000 and does not exceed $500,000;

64 per centum of the amount by which the net income exceeds $500,000 and does not exceed $1,000,000;

65 per centum of the amount by which the net income exceeds $1,000,000;

(2) For the calendar year 1922 and each calendar year thereafter, a surtax equal to the sum of the following:

1 per centum of the amount by which the net income exceeds $6,000 and does not exceed $10,000;

2 per centum of the amount by which the net income exceeds $10,000 and does not exceed $12,000;

3 per centum of the amount by which the net income exceeds $12,000 and does not exceed $14,000;

4 per centum of the amount by which the net income exceeds $14,000 and does not exceed $16,000;

5 per centum of the amount by which the net income exceeds $16,000 and does not exceed $18,000;

6 per centum of the amount by which the net income exceeds $18,000 and does not exceed $20,000;

8 per centum of the amount by which the net income exceeds $20,000 and does not exceed $22,000;

9 per centum of the amount by which the net income exceeds $22,000 and does not exceed $24,000;

10 per centum of the amount by which the net income exceeds $24,000 and does not exceed $26,000;

11 per centum of the amount by which the net income exceeds $26,000 and does not exceed $28,000;

12 per centum of the amount by which the net income exceeds $28,000 and does not exceed $30,000;

13 per centum of the amount by which the net income exceeds $30,000 and does not exceed $32,000;

15 per centum of the amount by which the net income exceeds $32,000 and does not exceed $36,000;

16 per centum of the amount by which the net income exceeds $36,000 and does not exceed $38,000;

17 per centum of the amount by which the net income exceeds $38,000 and does not exceed $40,000;

18 per centum of the amount by which the net income exceeds $40,000 and does not exceed $42,000;

19 per centum of the amount by which the net income exceeds $42,000 and does not exceed $44,000;

20 per centum of the amount by which the net income exceeds $44,000 and does not exceed $46,000;

21 per centum of the amount by which the net income exceeds $46,000 and does not exceed $48,000;

22 per centum of the amount by which the net income exceeds $48,000 and does not exceed $50,000;

23 per centum of the amount by which the net income exceeds $50,000 and does not exceed $52,000;

24 per centum of the amount by which the net income exceeds $52,000 and does not exceed $54,000;

25 per centum of the amount by which the net income exceeds $54,000 and does not exceed $56,000;

26 per centum of the amount by which the net income exceeds $56,000 and does not exceed $58,000;

27 per centum of the amount by which the net income exceeds $58,000 and does not exceed $60,000;

28 per centum of the amount by which the net income exceeds $60,000 and does not exceed $62,000;

29 per centum of the amount by which the net income exceeds $62,000 and does not exceed $64,000;

30 per centum of the amount by which the net income exceeds $64,000 and does not exceed $66,000;

31 per centum of the amount by which the net income exceeds $66,000 and does not exceed $68,000;

32 per centum of the amount by which the net income exceeds $68,000 and does not exceed $70,000;

33 per centum of the amount by which the net income exceeds $70,000 and does not exceed $72,000;

34 per centum of the amount by which the net income exceeds $72,000 and does not exceed $74,000;

35 per centum of the amount by which the net income exceeds $74,000 and does not exceed $76,000;

36 per centum of the amount by which the net income exceeds $76,000 and does not exceed $78,000;

37 per centum of the amount by which the net income exceeds $78,000 and does not exceed $80,000;

38 per centum of the amount by which the net income exceeds $80,000 and does not exceed $82,000;

39 per centum of the amount by which the net income exceeds $82,000 and does not exceed $84,000;

40 per centum of the amount by which the net income exceeds $84,000 and does not exceed $86,000;

41 per centum of the amount by which the net income exceeds $86,000 and does not exceed $88,000;

42 per centum of the amount by which the net income exceeds $88,000 and does not exceed $90,000;

43 per centum of the amount by which the net income exceeds $90,000 and does not exceed $92,000;

44 per centum of the amount by which the net income exceeds $92,000 and does not exceed $94,000;

45 per centum of the amount by which the net income exceeds $94,000 and does not exceed $96,000;

46 per centum of the amount by which the net income exceeds $96,000 and does not exceed $98,000;

47 per centum of the amount by which the net income exceeds $98,000 and does not exceed $100,000;

48 per centum of the amount by which the net income exceeds $100,000 and does not exceed $150,000;

49 per centum of the amount by which the net income exceeds $150,000 and does not exceed $200,000;

50 per centum of the amount by which the net income exceeds $200,000.

(b) In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this section attributable to such sale shall not exceed, for the calendar year 1921, 20 per centum, and for each calendar year thereafter 16 per centum of the selling price of such property or interest.

Net Income of Individuals Defined

Sec. 212. (a) That in the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by section 214.

(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

(c) If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 226.

Gross Income Defined

Sec. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts

of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items (except as provided in subdivision (e) of section 201) shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; but

(b) Does not include the following items, which shall be exempt from taxation under this title:

(1) The proceeds of life insurance policies paid upon the death of the insured;

(2) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term, or at the maturity of the term mentioned in the contract or upon surrender of the contract;

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income);

(4) Interest upon (a) the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916; or (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation. In the case of obligations of the United States issued after September 1, 1917 (other than postal saving certificates of deposit) and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt to the taxpayer from income, war-profits and excess-profits taxes;

(5) The income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States;

(6) Amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness;

(7) Income derived from any public utility or the exercise of any

essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to the Government of any possession of the United States, or any political subdivision thereof.

Whenever any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, prior to September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility, no tax shall be levied under the provisions of this title upon the income derived from the operation of such public utility, so far as the payment thereof will impose a loss or burden upon such State, Territory, District of Columbia, or political subdivision; but this provision is not intended and shall not be construed to confer upon such person any financial gain or exemption or to relieve such person from the payment of a tax as provided for in this title upon the part or portion of such income to which such person is entitled under such contract;

(8) The income of a nonresident alien or a foreign corporation which consists exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States;

(9) Amounts received as compensation, family allotments and allowances under the provisions of the War Risk Insurance and the Vocational Rehabilitation Acts, or as pensions from the United States for service of the beneficiary or another in the military or naval forces of the United States in time of war;

(10) So much of the amount received by an individual after December 31, 1921, and before January 1, 1927, as dividends or interest from domestic building and loan associations, operated exclusively for the purpose of making loans to members, as does not exceed $300;

(11) The rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel as part of his compensation;

(12) The receipts of shipowners' mutual protection and indemnity associations, not organized for profit, and no part of the net earnings of which inures to the benefit of any private stockholder or member but such corporations shall be subject as other persons to the tax upon their net income from interest, dividends, and rent;

(13) In the case of an individual, amounts distributed as dividends to or for his benefit by a corporation organized under the China Trade Act, 1922, if, at the time of such distribution, he is a citizen of China resident therein and the equitable right to the income of the shares of stock in the corporation is in good faith vested in him.

(c) In the case of a nonresident alien individual, gross income means only the gross income from sources within the United States, determined under the provisions of section 217.

Deductions Allowed Individuals

SEC. 214. (a) That in computing net income there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity;

(2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;

(3) Taxes paid or accrued within the taxable year except (a) income, war-profits, and excess-profits taxes imposed by the authority of the United States, (b) so much of the income, war-profits and excess-profits taxes, imposed by the authority of any foreign country or possession of the United States, as is allowed as a credit under section 222, (c) taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and (d) taxes imposed upon the taxpayer upon his interest as shareholder or member of a corporation, which are paid by the corporation without reimbursement from the taxpayer. For the purpose of this paragraph estate, inheritance, legacy, and succession taxes accrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business;

(5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business; but in the case of a nonresident alien individual only if and to the extent that the profit, if such transaction had resulted in a profit, would be taxable under this title. No deduction shall be allowed under this paragraph for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed;

(6) Losses sustained during the taxable year of property not con-

nected with the trade or business (but in the case of a nonresident alien individual only property within the United States) if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise. Losses allowed under paragraphs (4), (5), and (6) of this subdivision shall be deducted as of the taxable year in which sustained unless, in order to clearly reflect the income, the loss should, in the opinion of the Commissioner, be accounted for as of a different period. In case of losses arising from destruction of or damage to property, where the property so destroyed or damaged was acquired before March 1, 1913, the deductions shall be computed upon the basis of its fair market price or value as of March 1, 1913;

(7) Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part;

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of such property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913;

(9) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the war against the German Government, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of such war, there shall be allowed, for any taxable year ending before March 3, 1924 (if claim therefor was made at the time of filing return for the taxable year 1918, 1919, 1920, or 1921) a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Act of Congress as a deduction in computing net income. At any time before March 3, 1924, the Commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the income, war-profits, and excess-profits taxes for the year or years affected shall be redetermined; and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252;

(10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,*

That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter: *And provided further,* That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

(11) Contributions or gifts made within the taxable year to or for the use of: (A) The United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes; (B) any corporation, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including posts of the American Legion or the women's auxiliary units thereof, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; or (C) the special fund for vocational rehabilitation authorized by section 7 of the Vocational Rehabilitation Act; to an amount which in all the above cases combined does not exceed 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph. In case of a nonresident alien individual this deduction shall be allowed only as to contributions or gifts made to domestic corporations, or to community chests, funds or foundations, created in the United States, or to such vocational rehabilitation fund. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner, with the approval of the Secretary;

(12) If property is compulsorily or involuntarily converted into cash or its equivalent as a result of (A) its destruction in whole or in part, (B) theft or seizure, or (C) an exercise of the power of requisition or condemnation, or the threat or imminence thereof; and if the taxpayer proceeds forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a cor-

poration owning such other property, or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of a gain derived as the portion of the proceeds so expended bears to the entire proceeds. The provisions of this paragraph prescribing the conditions under which a deduction may be taken in respect of the proceeds or gains derived from the compulsory or involuntary conversion of property into cash or its equivalent, shall apply so far as may be practicable to the exemption or exclusion of such proceeds or gains from gross income under prior income, war-profits and excess-profits tax acts.

(b) In the case of a nonresident alien individual, the deductions allowed in subdivision (a), except those allowed in paragraphs (5), (6), and (11), shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in section 217 under rules and regulations prescribed by the Commissioner with the approval of the Secretary. In the case of a citizen entitled to the benefits of section 262 the deductions shall be the same and shall be determined in the same manner as in the case of a nonresident alien individual.

Items Not Deductible

SEC. 215. (a) That in computing net income no deduction shall in any case be allowed in respect of—

(1) Personal, living, or family expenses;

(2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate;

(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made; or

(4) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

(b) Amounts paid under the laws of any State, Territory, District of Columbia, possession of the United States, or foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time, nor by any deduction allowed by this Act for the purpose of computing the net income of an estate or trust but not allowed under the laws of such State, Territory, District of Columbia, possession of the United States, or foreign country for the purpose of computing the income to which such holder is entitled.

Credits Allowed Individuals

SEC. 216. That for the purpose of the normal tax only there shall be allowed the following credits:

(a) The amount received as dividends (1) from a domestic corporation other than a corporation entitled to the benefits of section 262, and other than a corporation organized under the China Trade Act, 1922, or (2) from a foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of section 217;

(b) The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under section 213;

(c) In the case of a single person, a personal exemption of $1,000; or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,500, unless the net income is in excess of $5,000, in which case the personal exemption shall be $2,000. A husband and wife living together shall receive but one personal exemption. The amount of such personal exemption shall be $2,500, unless the aggregate net income of such husband and wife is in excess of $5,000, in which case the amount of such personal exemption shall be $2,000. If such husband and wife make separate returns, the personal exemption may be taken by either or divided between them. In no case shall the reduction of the personal exemption from $2,500 to $2,000 operate to increase the tax, which would be payable if the exemption were $2,500, by more than the amount of the net income in excess of $5,000;

(d) $400 for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective.

(e) In the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the personal exemption shall be only $1,000, and he shall not be entitled to the credit provided in subdivision (d).

(f) The credits allowed by subdivisions (c), (d), and (e) of this section shall be determined by the status of the taxpayer on the last day of the period for which the return of income is made; but in the case of an individual who dies during the taxable year, such credits shall be determined by his status at the time of his death, and in such case full credits shall be allowed to the surviving spouse, if any, according to his or her status at the close of the period for which such survivor makes return of income.

Net Income of Nonresident Alien Individuals

SEC. 217. (a) That in the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the following items of gross income shall be treated as income from sources within the United States:

(1) Interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including (A) interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States and not having an office or place of business therein, or (B) interest received from a resident alien individual or a resident foreign corporation when it is shown to the satisfaction of the Commissioner that less than 20 per centum of the gross income of such resident payor has been derived from sources within the United States, as determined under the provisions of this section, for the three-year period ending with the close of the taxable year of such payor, or for such part of such period immediately preceding the close of such taxable year as may be applicable;

(2) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (B) from a foreign corporation unless less than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of this section;

(3) Compensation for labor or personal services performed in the United States;

(4) Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property; and

(5) Gains, profits and income from the sale of real property located in the United States.

(b) From the items of gross income specified in subdivision (a) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States.

(c) The following items of gross income shall be treated as income from sources without the United States:

(1) Interest other than that derived from sources within the United States as provided in paragraph (1) of subdivision (a);

(2) Dividends other than those derived from sources within the United States as provided in paragraph (2) of subdivision (a);

(3) Compensation for labor or personal service performed without the United States;

(4) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using without the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property; and

(5) Gains, profits, and income from the sale of real property located without the United States;

(d) From the items of gross income specified in subdivision (c) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as net income from sources without the United States.

(e) Items of gross income, expenses, losses and deductions, other than those specified in subdivisions (a) and (c), shall be allocated or apportioned to sources within or without the United States under rules and regulations prescribed by the Commissioner with the approval of the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the net income therefrom) the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States. In the case of gross income derived from sources partly within and partly without the United States, the net income may first be computed by deducting the expenses, losses or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which can not definitely be allocated to some item or class of gross income; and the portion of such net income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Commissioner with the approval of the Secretary. Gains, profits and income from (1) transportation or other services rendered partly within and partly without the United States, or (2) from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, or produced (in whole or in part) by the taxpayer without and sold within the United States, shall be treated as derived partly from sources within and partly from sources without the United States. Gains, profits and income derived from the purchase of personal property within and its sale without the United States or from the purchase of personal property without and its sale within the United States, shall be treated as derived entirely from the country in which sold.

(f) As used in this section the words "sale" or "sold" include "ex-

change" or "exchanged"; and the word "produced" includes "created," "fabricated," "manufactured," "extracted," "processed," "cured," or "aged."

(g) A nonresident alien individual or a citizen entitled to the benefits of section 262 shall receive the benefit of the deductions and credits allowed in this title only by filing or causing to be filed with the collector a true and accurate return of his total income received from all sources corporate or otherwise in the United States in the manner prescribed in this title; including therein all the information which the Commissioner may deem necessary for the calculation of such deductions and credits: *Provided,* That the benefit of the credit allowed in subdivision (e) of section 216 may, in the discretion of the Commissioner, be received by filing a claim therefor with the withholding agent. In case of failure to file a return, the collector shall collect the tax on such income, and all property belonging to such nonresident alien individual or foreign trader shall be liable to distraint for the tax.

Partnerships and Personal Service Corporations

SEC. 218. (a) That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.

(b) The partner shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the partnership.

(c) The net income of the partnership shall be computed in the same manner and on the same basis as provided in section 212 except that the deduction provided in paragraph (11) of subdivision (a) of section 214 shall not be allowed.

(d) Personal service corporations shall not be subject to taxation under this title, but the individual stockholders thereof shall be taxed in the same manner as the members of partnerships. All the provisions of this title relating to partnerships and the members thereof shall so far as practicable apply to personal service corporations and the stockholders thereof: *Provided,* That for the purpose of this subdivision amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees; and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares.

This subdivision shall not be in effect after December 31, 1921. In the case of a personal service corporation having a fiscal year beginning in 1921 and ending in 1922, amounts distributed prior to January 1, 1922, to its stockholders out of earnings or profits accumulated after December 31, 1920, shall be taxed to the distributees; and the stockholders of record on December 31, 1921, shall be taxed upon their distributive shares of the difference (if any) between such distributive profits and the portion of the corporation's net income assignable to the calendar year 1921, determined in the manner provided in clause (1) of subdivision (c) of section 205 of this Act.

Estates and Trusts

SEC. 219. (a) That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including—

(1) Income received by estates of deceased persons during the period of administration or settlement of the estate;

(2) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(3) Income held for future distribution under the terms of the will or trust; and

(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct.

(b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, except that (in lieu of the deduction authorized by paragraph (11) of subdivision (a) of section 214) there shall also be allowed as a deduction, without limitation, any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in paragraph (11) of subdivision (a) of section 214. In cases in which there is any income of the class described in paragraph (4) of subdivision (a) of this section the fiduciary shall include in the return a statement of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable to each beneficiary, whether or not distributed before the close of the taxable year for which the return is made.

(c) In cases under paragraphs (1), (2), or (3) of subdivision (a) or in any other case within subdivision (a) of this section except paragraph (4) thereof the tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary, except that in determining the net income of the estate of any deceased person during the period of administration or settlement there may be deducted the amount of any income properly paid or credited to any legatee, heir or other beneficiary.

In such cases the estate or trust shall, for the purpose of the normal tax, be allowed the same credits as are allowed to single persons under section 216.

(d) In cases under paragraph (4) of subdivision (a), and in the case of any income of an estate during the period of administration or settlement permitted by subdivision (c) to be deducted from the net income upon which tax is to be paid by the fiduciary, the tax shall not be paid by the fiduciary, but there shall be included in computing the net income of each beneficiary that part of the income of the estate or trust for its taxable year which, pursuant to the instrument or order governing the distribution, is distributable to such beneficiary, whether distributed or not, or, if his taxable year is different from that of the estate or trust, then there shall be included in computing his net income his distributive share of the income of the estate or trust for its taxable year ending within the taxable year of the beneficiary. In such cases the beneficiary shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the estate or trust.

(e) In the case of an estate or trust the income of which consists both of income of the class described in paragraph (4) of subdivision (a) of this section and other income, the net income of the estate or trust shall be computed and a return thereof made by the fiduciary in accordance with subdivision (b) and the tax shall be imposed, and shall be paid by the fiduciary in accordance with subdivision (c), except that there shall be allowed as an additional deduction in computing the net income of the estate or trust that part of its income of the class described in paragraph (4) of subdivision (a) which, pursuant to the instrument or order governing the distribution, is distributable during its taxable year to the beneficiaries. In cases under this subdivision there shall be included, as provided in subdivision (d) of this section, in computing the net income of each beneficiary, that part of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable during the taxable year to such beneficiary.

(f) A trust created by an employer as a part of a stock bonus or profit-sharing plan for the exclusive benefit of some or all of his employees, to which contributions are made by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, shall not be taxable under this section, but the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him. Such distributees shall for the purpose of the normal tax be allowed as credits that part of the amount so distributed or made available as represents the items specified in subdivisions (a) and (b) of section 216.

Evasion of Surtaxes by Incorporation

SEC. 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 25 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax: *Provided,* That if all the stockholders or members of such corporation agree thereto, the Commissioner may, in lieu of all income, war-profits and excess-profits taxes imposed upon the corporation for the taxable year, tax the stockholders or members of such corporation upon their distributive shares in the net income of the corporation for the taxable year in the same manner as provided in subdivision (a) of section 218 in the case of members of a partnership. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

Payment of Individual's Tax at Source

SEC. 221. (a) That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States having the control, receipt, custody, disposal, or payment of interest (except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States and not having an office or place of business therein), rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, of any nonresident alien individual or partnership composed in whole or in part of nonresident aliens (other than income received as dividends of the class allowed as a credit by subdivision (a) of section 216) shall (except in the cases provided for in subdivision (b) and except as otherwise provided in regulations prescribed by the Commissioner

under section 217) deduct and withhold from such annual or periodical gains, profits and income a tax equal to 8 per centum thereof: *Provided,* That the Commissioner may authorize such tax to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent.

(b) In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon, or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods and whether payable to a nonresident alien individual or to an individual citizen or resident of the United States or to a partnership: *Provided,* That the Commissioner may authorize such tax to be deducted and withheld in the case of interest upon any such bonds, mortgages, deeds of trust, or other obligations, the owners of which are not known to the withholding agent. Such deduction and withholding shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1 a signed notice in writing claiming the benefit of the credits provided in subdivisions (c) and (d) of section 216; nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the Commissioner under subdivision (g) of section 217.

(c) Every individual, corporation, or partnership required to deduct and withhold any tax under this section shall make return thereof on or before March 1 of each year and shall on or before June 15 pay the tax to the official of the United States Government authorized to receive it. Every such individual, corporation, or partnership is hereby made liable for such tax and is hereby indemnified against the claims and demands of any individual, corporation, or partnership for the amount of any payment made in accordance with the provisions of this section.

(d) Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.

(e) If any tax required under this section to be deducted and withheld is paid by the recipient of the income, it shall not be re-collected from the withholding agent; nor in cases in which the tax is so paid shall any penalty is imposed upon or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

Credit for Taxes in Case of Individuals

SEC. 222. (a) That the tax computed under Part II of this title shall be credited with:

(1) In the case of a citizen of the United States the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country or to any possession of the United States; and

(2) In the case of a resident of the United States, the amount of any such taxes paid during the taxable year to any possession of the United States; and

(3) In the case of an alien resident of the United States, the amount of any such taxes paid during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(4) In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership or the estate or trust paid during the taxable year to a foreign country or to any possession of the United States, as the case may be.

(5) The above credits shall not be allowed in the case of a citizen entitled to the benefits of section 262; and in no other case shall the amount of credit taken under this subdivision exceed the same proportion of the tax, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits and excess-profits taxes imposed by any foreign country or possession of the United States) from sources without the United States bears to his entire net income (computed without such deduction) for the same taxable year.

(b) If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Commissioner, who shall redetermine the amount of the tax due under Part II of this title for the year or years affected, and the amount of tax due upon such redetermination, if any, shall be paid by the taxpayer upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the taxpayer to give a bond with sureties satisfactory to and to be approved by the Commissioner in such penal sum as the Commissioner may require, conditioned for the payment by the taxpayer of any amount of tax found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(c) These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources without the United States, and all other information necessary for the verification and computation of such credits.

(d) If the taxpayer makes a return for a fiscal year beginning in 1920 and ending in 1921, the credit for the entire fiscal year shall, notwithstanding any provision of this Act, be determined under the provisions of this section; and the Commissioner is authorized to disallow, in whole or part, any such credit which he finds has already been taken by the taxpayer.

Individual Returns

SEC. 223. (a) That the following individuals shall each make under oath a return stating specifically the items of his gross income and the deductions and credits allowed under this title—

(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife;

(2) Every individual having a net income for the taxable year of $2,000 or over, if married and living with husband or wife; and

(3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income.

(b) If a husband and wife living together have an aggregate net income for the taxable year of $2,000 or over, or an aggregate gross income for such year of $5,000 or over—

(1) Each shall make such a return, or

(2) The income of each shall be included in a single joint return, in which case the tax shall be computed on the aggregate income.

(c) If the taxpayer is unable to make his own return, the return shall be made by a duly authorized agent or by the guardian or other person charged with the care of the person or property of such taxpayer.

Partnership Returns

SEC. 224. That every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners.

Fiduciary Returns

SEC. 225. (a) That every fiduciary (except a receiver appointed by authority of law in possession of part only of the property of an individual) shall make under oath a return for any of the following individuals, estates, or trusts for which he acts, stating specifically the items of gross income thereof and the deductions and credits allowed under this title—

(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife;

(2) Every individual having a net income for the taxable year of $2,000 or over, if married and living with husband or wife;

(3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income;

(4) Every estate or trust the net income of which for the taxable year is $1,000 or over; and

(5) Every estate or trust of which any beneficiary is a nonresident alien.

(b) Under such regulations as the Commissioner with the approval of the Secretary may prescribe a return made by one of two or more joint fiduciaries and filed in the office of the collector of the district where such fiduciary resides shall be sufficient compliance with the above requirement. Such fiduciary shall make oath (1) that he has sufficient knowledge of the affairs of the individual, estate or trust for which the return is made, to enable him to make the return, and (2) that the return is to the best of his knowledge and belief, true and correct. Any fiduciary required to make a return under this Act shall be subject to all the provisions of this Act which apply to individuals.

Returns for a Period of Less Than Twelve Months

SEC. 226. (a) That if a taxpayer, with the approval of the Commissioner, changes the basis of computing net income from fiscal year to calendar year a separate return shall be made for the period between the close of the last fiscal year for which return was made and the following December 31. If the change is from calendar year to fiscal year, a separate return shall be made for the period between the close of the last calendar year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year a separate return shall be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year.

(b) In all cases where a separate return is made for a part of a taxable year the net income shall be computed on the basis of such period for which separate return is made, and the tax shall be paid thereon at the rate for the calendar year in which such period is included.

(c) In the case of a return for a period of less than one year the net income shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in such period; and the tax shall be such part of a tax computed on such annual basis as the number of months in such period is of twelve months.

Time and Place for Filing Individual, Partnership, and Fiduciary Returns

SEC. 227. (a) That returns (except in the case of nonresident aliens) shall be made on or before the fifteenth day of the third month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of March. In the case of a nonresident alien individual returns shall be

made on or before the fifteenth day of the sixth month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of June. The Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.

(b) Returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

Understatement in Returns

Sec. 228. That if the collector or deputy collector has reason to believe that the amount of any income returned is understated, he shall give due notice to the taxpayer making the return to show cause why the amount of the return should not be increased, and upon proof of the amount understated, may increase the same accordingly. Such taxpayer may furnish sworn testimony to prove any relevant facts and if dissatisfied with the decision of the collector may appeal to the Commissioner for his decision, under such rules of procedure as may be prescribed by the Commissioner with the approval of the Secretary.

Incorporation of Individual or Partnership Business

Sec. 229. That in the case of the organization as a corporation within four months after the passage of this act of any trade or business in which capital is a material income-producing factor, and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1921, to the date of such organization may at the option of the individual or partnership be taxed as the net income of a corporation is taxed under Titles II and III; in which event the net income and invested capital of such trade or business shall be computed as if such corporation had been in existence on and after January 1, 1921, and the undistributed profits or earnings of such trade or business shall not be subject to the surtaxes imposed in section 211, but amounts distributed on and after January 1, 1921, from the earnings or profits of such trade or business accumulated after December 31, 1920, shall be taxed to the recipients as dividends; and all the provisions of Titles II and III relating to corporations shall so far as practicable apply to such trade or business: *Provided,* That this section shall not apply to any trade or business, the net income of which for the taxable year 1921 was less than 20 per centum of its invested capital for such year: *Provided further,* That any taxpayer who takes advantage of this section shall pay the tax imposed by section 1000 of the Revenue Act of 1918 as if such taxpayer had been a corporation on and after January 1, 1921.

Part III.—Corporations.

Tax on Corporations

Sec. 230. That, in lieu of the tax imposed by section 230 of the Revenue Act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:

(a) For the calendar year 1921, 10 per centum of the amount of the net income in excess of the credits provided in section 236; and

(b) For each calendar year thereafter, 12½ per centum of the amount of the net income in excess of the credits provided in sections 236 and 264.

Conditional and Other Exemptions of Corporations

Sec. 231. That the following organizations shall be exempt from taxation under this title—

(1) Labor, agricultural, or horticultural organizations;

(2) Mutual savings banks not having a capital stock represented by shares;

(3) Fraternal beneficiary societies, orders, or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system; and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;

(4) Domestic building and loan associations substantially all the business of which is confined to making loans to members; and cooperative banks without capital stock organized and operated for mutual purposes and without profit;

(5) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(7) Business leagues, chambers of commerce, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare;

(9) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private stockholder or member;

(10) Farmers' or other mutual hail, cyclone, or fire insurance companies, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting expenses;

(11) Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them; or organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such supplies and equipment to such members at actual cost, plus necessary expenses;

(12) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title;

(13) Federal land banks and national farm-loan associations as provided in section 26 of the Act approved July 17, 1916, entitled "An Act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create Government depositaries and financial agents for the United States, and for other purposes";

(14) Personal service corporations. This subdivision shall not be in effect after December 31, 1921.

Net Income of Corporations Defined

SEC. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226. In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the computation shall also be made in the manner provided in section 217.

Gross Income of Corporations Defined

SEC. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means the gross income as defined in sections 213 and 217, except that mutual marine insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance.

(b) In the case of a foreign corporation, gross income means only gross income from sources within the United States, determined (except in the case of insurance companies subject to the tax imposed by sections 243 or 246) in the manner provided in section 217.

Deductions Allowed Corporations

SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity;

(2) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;

(3) Taxes paid or accrued within the taxable year except (a) income, war-profits, and excess- profits taxes imposed by the authority of the United States, (b) so much of the income, war-profits and excess-profits taxes imposed by the authority of any foreign country or possession of the United States as is allowed as a credit under section 238, and (c) taxes assessed against local benefits of a kind tending to increase the value of the property assessed. In the case of obligors specified in subdivision (b) of section 221 no deduction for the payment of the tax imposed by this title, or any other tax paid pursuant to the contract or provision referred to in that subdivision, shall be allowed nor shall such tax be included in the gross income of the obligee. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed upon a shareholder or member of a corporation upon his interest as shareholder or member which are paid by the corporation without reimbursement from the shareholder or member, but in such cases no deduction shall be allowed the shareholder or member for the amount of such taxes. For the purpose of this paragraph, estate, inheritance, legacy, and succession taxes accrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise; unless, in order to clearly reflect the income, the loss should in the opinion of the Commissioner be accounted for as of a different period. No deduction shall be allowed for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the tax-

payer for any period after such sale or other disposition, unless such claim is made by a dealer in stock or securities and with respect to a transaction made in the ordinary course of its business. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed. In case of losses arising from destruction of or damage to property, where the property so destroyed or damaged was acquired before March 1, 1913, the deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913;

(5) Debts ascertained to be worthless and charged off within the taxable year (or in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt to be charged off in part;

(6) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, and other than a corporation organized under the China Trade Act, 1922, or (B) from any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under section 217;

(7) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of such property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913;

(8) In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the war against the German Government, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of such war, there shall be allowed, for any taxable year ending before March 3, 1924 (if claim therefor was made at the time of filing return for the taxable year 1918, 1919, 1920, or 1921) a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Acts of Congress as a deduction in computing net income. At any time before March 3, 1924, the Commissioner may, and at the request of the taxpayer shall, reexamine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the income, war-profits, and excess-profits taxes for the year or years affected shall be redetermined and the amount of tax due

upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252;

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided,* That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter: *And provided further,* That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commisioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

(10) In the case of insurance companies (other than life insurance companies), in addition to the above (unless otherwise allowed): (A) The net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds); and (B) the sums other than dividends paid within the taxable year on policy and annuity contracts. After December 31, 1921, this subdivision shall apply only to mutual insurance companies other than life insurance companies;

(11) In the case of corporations (except those taxed under section 243) issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan continuing for life and not subject to cancellation, in addition to the above, such portion of the net addition (not required by law) made within the taxable year to reserve funds as the Commissioner finds to be required for the protection of the holders of such policies only. This subdivision shall not be in effect after December 31, 1921;

(12) In the case of mutual marine insurance companies, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, and paragraph (14), unless otherwise allowed, amounts repaid to policyholders on account of premiums previously paid by them,

and interest paid upon such amounts between the ascertainment and the payment thereof;

(13) In the case of mutual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, and paragraph (14), unless otherwise allowed, the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves;

(14) If property is compulsorily or involuntarily converted into cash or its equivalent as a result of (A) its destruction in whole or in part, (B) theft or seizure, or (C) an exercise of the power of requisition or condemnation, or the threat or imminence thereof; and if the taxpayer proceeds forthwith in good faith under regulations prescribed by the Commissioner with the approval of the Secretary, to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a corporation owning such other property, or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of the gain derived as the portion of the proceeds so expended bears to the entire proceeds. The provision of this paragraph prescribing the conditions under which a deduction may be taken in respect of the proceeds or gains derived from the compulsory or involuntary conversion of property into cash or its equivalent, shall apply so far as may be practicable to the exemption or exclusion of such proceeds or gains from gross income under prior income, war-profits and excess-profits tax Acts.

(b) In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the deductions allowed in subdivision (a) shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in section 217 under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

Items Not Deductible by Corporations

Sec. 235. That in computing net income no deduction shall in any case be allowed in respect of any of the items specified in section 215.

Credits Allowed Corporations

Sec. 236. That for the purpose only of the tax imposed by section 230 there shall be allowed the following credits:

(a) The amount received as interest upon obligations of the United

States and bonds issued by the War Finance Corporation, which is included in gross income under section 233;

(b) In the case of a domestic corporation the net income of which is $25,000 or less, a specific credit of $2,000; but if the net income is more than $25,000 the tax imposed by section 230 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000; and

(c) The amount of any war-profits and excess-profits taxes imposed by Act of Congress for the same taxable year. The credit allowed by this subdivision shall be determined as follows:

(1) In the case of a corporation which makes return for a fiscal year beginning in 1920 and ending in 1921, in computing the income tax as provided in subdivision (a) of section 205, the portion of the war-profits and excess-profits tax computed for the entire period under clause (1) of subdivision (a) of section 335 shall be credited against the net income computed for the entire period as provided in clause (1) of subdivision (a) of section 205, and the portion of the war-profits and excess-profits tax computed for the entire period under clause (2) of subdivision (a) of section 335 shall be credited against the net income computed for the entire period as provided in clause (2) of subdivision (a) of section 205.

(2) In the case of a corporation which makes return for a fiscal year beginning in 1921 and ending in 1922, in computing the income tax as provided in subdivision (b) of section 205, the war-profits and excess-profits tax computed under subdivision (b) of section 335 shall be credited against the net income computed for the entire period as provided in clause (1) of subdivision (b) of section 205.

Payment of Corporation Income Tax at Source

Sec. 237. That in the case of foreign corporations subject to taxation under this title not engaged in trade or business within the United States and not having any office or place of business therein, there shall be deducted and withheld at the source in the same manner and upon the same items of income as is provided in section 221 a tax equal to 12½ per centum thereof (but during the calendar year 1921 only 10 per centum), and such tax shall be returned and paid in the same manner and subject to the same conditions as provided in that section: *Provided,* That in the case of interest described in subdivision (b) of that section the deduction and withholding shall be at the rate of 2 per centum.

Credit for Taxes in Case of Corporations

Sec. 238. (a) That in the case of a domestic corporation the tax imposed by this title, plus the war-profits and excess-profits taxes, if any, shall be credited with the amount of any income, war-profits, and excess-profits taxes paid during the same taxable year to any foreign country, or to any possession of the United States: *Provided,* That the

amount of credit taken under this subdivision shall in no case exceed the same proportion of the taxes, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits, and excess-profits taxes imposed by any foreign country or possession of the United States) from sources without the United States bears to its entire net income (computed without such deduction) for the same taxable year. In the case of domestic insurance companies subject to the tax imposed by section 243 or 246, the term "net income", as used in this subdivision means net income as defined in sections 245 and 246, respectively.

(b) If accrued taxes when paid differ from the amounts claimed as credits by the corporation, or if any tax paid is refunded in whole or in part, the corporation shall at once notify the Commissioner, who shall redetermine the amount of the income, war-profits and excess-profits taxes for the year or years affected, and the amount of taxes due upon such redetermination, if any, shall be paid by the corporation upon notice and demand by the collector, or the amount of taxes overpaid, if any, shall be credited or refunded to the corporation in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the corporation to give a bond with sureties satisfactory to and to be approved by him in such penal sum as he may require, conditioned for the payment by the taxpayer of any amount of taxes found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(c) These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources without the United States, and all other information necessary for the verification and computation of such credit.

(d) If a domestic corporation makes a return for a fiscal year beginning in 1920 and ending in 1921, the credit for the entire fiscal year shall, notwithstanding any provision of this Act, be determined under the provisions of this section; and the Commissioner is authorized to disallow, in whole or in part, any such credit which he finds has already been taken by the taxpayer.

(e) For the purposes of this section a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends (not deductible under section 234) in any taxable year shall be deemed to have paid the same proportion of any income, war-profits, or excess-profits taxes paid by such foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits: *Provided,* That the credit allowed to any domestic corporation under this subdivision shall in no case exceed the same proportion of the taxes against which it is

credited, which the amount of such dividends bears to the amount of the entire net income of the domestic corporation in which such dividends are included. The term "accumulated profits" when used in this subdivision in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war-profits, and excess-profits taxes imposed upon or with respect to such profits or income; and the Commissioner with the approval of the Secretary shall have full power to determine from the accumulated profits of what year or years such dividends were paid; treating dividends paid in the first sixty days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings. In the case of a foreign corporation, the income, war-profits, and excess-profits taxes of which are determined on the basis of an accounting period of less than one year, the word "year" as used in this subdivision shall be construed to mean such accounting period.

(f) For the purposes of this section a corporation entitled to the benefits of section 262 or 264 shall be treated as a foreign corporation.

Corporation Returns

SEC. 239. (a) That every corporation subject to taxation under this title and every personal service corporation shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title. The return shall be sworn to by the president, vice president, or other principal officer and by the treasurer or assistant treasurer. If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return shall be made by the agent. In cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.

(b) Returns made under this section shall be subject to the provisions of sections 226 and 228. When return is made under section 226 the credit provided in subdivision (b) of section 236 shall be reduced to an amount which bears the same ratio to the full credit therein provided as the number of months in the period for which such return is made bears to twelve months.

(c) There shall be included in the return or appended thereto a statement of such facts as will enable the Commissioner to determine the portion of the earnings or profits of the corporation (including gains, profits and income not taxed) accumulated during the taxable year for

which the return is made, which have been distributed or ordered to be distributed, respectively, to its stockholders or members during such year.

Consolidated Returns of Corporations

SEC. 240. (a) That corporations which are affiliated within the meaning of this section may, for any taxable year beginning on or after January 1, 1922, make separate returns or, under regulations prescribed by the Commissioner with the approval of the Secretary, make a consolidated return of net income for the purpose of this title, in which case the taxes thereunder shall be computed and determined upon the basis of such return. If return is made on either of such bases, all returns thereafter made shall be upon the same basis unless permission to change the basis is granted by the Commissioner.

(b) In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportion as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each. There shall be allowed in computing the income tax only one specific credit computed as provided in subdivision (b) of section 236.

(c) For the purpose of this section two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others, or (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests.

A corporation organized under the China Trade Act, 1922, shall not be deemed to be affiliated with any other corporation within the meaning of this section.

(d) For the purposes of this section a corporation entitled to the benefits of section 262 shall be treated as a foreign corporation: *Provided*, That in any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses.

(e) Corporations which are affiliated within the meaning of this section shall make consolidated returns for any taxable year beginning prior to January 1, 1922, in the same manner and subject to the same conditions as provided by the Revenue Act of 1918.

Time and Place for Filing Corporate Returns

SEC. 241. (a) That returns of corporations shall be made at the same time as is provided in subdivision (a) of section 227, except that

in the case of foreign corporations not having any office or place of business in the United States returns shall be made at the same time as provided in section 227 in the case of a nonresident alien individual.

(b) Returns shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.

Taxes on Insurance Companies

SEC. 242. That when used in this title the term "life insurance company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds.

SEC. 243. That in lieu of the taxes imposed by sections 230 and 1000 and by Title III, there shall be levied, collected, and paid for the calendar year 1921 and for each taxable year thereafter upon the net income of every life insurance company a tax as follows:

(1) In the case of a domestic life insurance company, the same percentage of its net income as is imposed upon other corporations by section 230;

(2) In the case of a foreign life insurance company, the same percentage of its net income from sources within the United States as is imposed upon the net income of other corporations by section 230.

SEC. 244. (a) That in the case of a life insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents.

(b) The term "reserve funds required by law" includes, in the case of assessment insurance, sums actually deposited by any company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation of the company or association exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

SEC. 245. (a) That in the case of a life insurance company the term "net income" means the gross income less—

(1) The amount of interest received during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title;

(2) An amount equal to the excess, if any, over the deduction specified in paragraph (1) of this subdivision, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, plus (in case of life insurance companies issuing policies covering life, health, and accident insurance combined in one

policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation) 4 per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only;

(3) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, and other than a corporation organized under the China Trade Act, 1922, or (B) from any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under section 217;

(4) An amount equal to 2 per centum of any sums held at the end of the taxable year as a reserve for dividends (other than dividends payable during the year following the taxable year) the payment of which is deferred for a period of not less than five years from the date of the policy contract;

(5) Investment expenses paid during the taxable year: *Provided*, That if any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 per centum of the book value of the mean of the invested assets held at the beginning and end of the taxable year;

(6) Taxes and other expenses paid during the taxable year exclusively upon or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and not including any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. The deduction allowed by this paragraph shall be allowed in the cases of taxes imposed upon a shareholder or member of a company upon his interest as shareholder or member, which are paid by the company without reimbursement from the shareholder or member, but in such cases no deduction shall be allowed the shareholder or member for the amount of such taxes;

(7) A reasonable allowance for the exhaustion, wear and tear of property, including a reasonable allowance for obsolescence. In the case of property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913;

(8) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;

(9) In the case of a domestic life insurance company, the net income of which (computed without the benefit of this paragraph) is $25,000 or less, the sum of $2,000; but if the net income is more than $25,000 the tax imposed by section 243 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000.

(b) No deduction shall be made under paragraphs (6) and (7) of subdivision (a) on account of any real estate owned and occupied in whole or in part by a life insurance company unless there is included in the return of gross income the rental value of the space so occupied. Such rental value shall be not less than a sum which in addition to any rents received from other tenants shall provide a net income (after deducting taxes, depreciation, and all other expenses) at the rate of 4 per centum per annum of the book value at the end of the taxable year of the real estate so owned or occupied.

(c) In the case of a foreign life insurance company the amount of its net income for any taxable year from sources within the United States shall be the same proportion of its net income for the taxable year from sources within and without the United States, which the reserve funds required by law and held by it at the end of the taxable year upon business transacted within the United States is of the reserve funds held by it at the end of the taxable year upon all business transacted.

To all interest, dividends and rents received during the taxable year,

SEC. 246. (a) That, in lieu of the taxes imposed by sections 230 and 1000, there shall be levied, collected and paid for the calendar year 1922, and for each taxable year thereafter, upon the net income of every insurance company (other than a life or mutual insurance company) a tax as follows:

(1) In the case of such a domestic insurance company the same percentage of its net income as is imposed upon other corporations by section 230;

(2) In the case of such a foreign insurance company the same percentage of its net income from sources within the United States as is imposed upon the net income of other corporations by section 230.

(b) In the case of an insurance company subject to the tax imposed by this section—

(1) The term "gross income" means the combined gross amount, earned during the taxable year, from investment income and from underwriting income as provided in this subdivision, computed on the basis of underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners;

(2) The term "net income" means the gross income as defined in earned during the taxable year from interest, dividends and rents, computed as follows:
paragraph (1) of this subdivision less the deductions allowed by section 247;

(3) The term "investment income" means the gross amount of income

add interest, dividends and rents due and accrued at the end of the taxable year, and deduct all interest, dividends and rents due and accrued at the end of the preceding taxable year;

(4) The term "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred;

(5) The term "premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance. To the result so obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year;

(6) The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year, and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year. To the result so obtained add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year;

(7) The term "expenses incurred" means all expenses shown on the annual statement approved by the National Convention of Insurance Commissioners, and shall be computed as follows:

To all expenses paid during the taxable year add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the net income subject to the tax imposed by this section there shall be deducted from expenses incurred as defined in this paragraph all expenses incurred which are not allowed as deductions by section 247.

Sec. 247. (a) That in computing the net income of an insurance company subject to the tax imposed by section 246 there shall be allowed as deductions:

(1) All ordinary and necessary expenses incurred, as provided in paragraph (1) of subdivision (a) of section 234;

(2) All interest as provided in paragraph (2) of subdivision (a) of section 234;

(3) Taxes as provided in paragraph (3) of subdivision (a) of section 234;

(4) Losses incurred;

(5) Bad debts in the nature of agency balances and bills receivable ascertained to be worthless and charged off within the taxable year;

(6) The amount received as dividends from corporations as provided in paragraph (6) of subdivision (a) of section 234;

(7) The amount of interest earned during the taxable year which under

paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title, and the amount of interest allowed as a credit under subdivision (a) of section 236;

(8) A reasonable allowance, for the exhaustion, wear and tear of property, as provided in paragraph (7) of subdivision (a) of section 234;

(9) In the case of such a domestic insurance company, the net income of which (computed without the benefit of this paragraph) is $25,000 or less, the sum of $2,000; but if the net income is more than $25,000 the tax imposed by section 246 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000.

(b) In the case of a foreign corporation the deductions allowed in this section shall be allowed to the extent provided in subdivision (b) of section 234.

(c) Nothing in this section or in section 246 shall be construed to permit the same item to be twice deducted.

Part IV.—Administrative Provisions.

Payment of Taxes

Sec. 250. (a) That except as otherwise provided in this section and sections 221 and 237 the tax shall be paid in four installments, each consisting of one-fourth of the total amount of the tax. The first installment shall be paid at the time fixed by law for filing the return, and the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after the time fixed by law for filing the return. Where an extension of time for filing a return is granted the time for payment of the first installment shall be postponed until the date of the expiration of the period of the extension, but the time for payment of the other installments shall not be postponed unless the Commissioner so provides in granting the extension. In any case in which the time for the payment of any installment is at the request of the taxpayer thus postponed, there shall be added as a part of such installment interest thereon at the rate of one-half of 1 per centum per month from the time it would have been due if no extension had been granted, until paid. If any installment is not paid when due, the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector.

The tax may at the option of the taxpayer be paid in a single payment instead of installments, in which case the total amount shall be paid on or before the time fixed by law for filing the return, or, where an extension of time for filing the return has been granted, on or before the expiration of the period of such extension.

(b) As soon as practicable after the return is filed, the Commissioner shall examine it. If it then appears that the correct amount of the tax is greater or less than that shown in the return, the installments shall be

recomputed. If the amount already paid exceeds that which should have been paid on the basis of the installments as recomputed, the excess so paid shall be credited against the subsequent installments; and if the amount already paid exceeds the correct amount of the tax, the excess shall be credited or refunded to the taxpayer in accordance with the provisions of section 252.

If the amount already paid is less than that which should have been paid, the difference, to the extent not covered by any credits due to the taxpayer under section 252 (hereinafter called "deficiency"), together with interest thereon at the rate of one-half of 1 per centum per month from the time the tax was due (or, if paid on the installment basis, on the deficiency of each installment from the time the installment was due), shall be paid upon notice and demand by the collector. If any part of the deficiency is due to negligence or intentional disregard of authorized rules and regulations with knowledge thereof, but without intent to defraud, there shall be added as part of the tax 5 per centum of the total amount of the deficiency in the tax, and interest in such a case shall be collected at the rate of 1 per centum per month on the amount of such deficiency in the tax from the time it was due (or, if paid on the installment basis, on the amount of the deficiency in each installment from the time the installment was due), which penalty and interest shall become due and payable upon notice and demand by the collector. If any part of the deficiency is due to fraud with intent to evade tax, then, in lieu of the penalty provided by section 3176 of the Revised Statutes, as amended, for false or fraudulent returns willfully made, but in addition to other penalties provided by law for false or fraudulent returns, there shall be added as part of the tax 50 per centum of the total amount of the deficiency in the tax. In such case the whole amount of the tax unpaid, including the penalty so added, shall become due and payable upon notice and demand by the collector.

(c) If the return is made pursuant to section 3176 of the Revised Statutes as amended, the amount of tax determined to be due under such return shall be paid upon notice and demand by the collector.

(d) The amount of income, excess-profits, or war-profits taxes due under any return made under this Act for the taxable year 1921 or succeeding taxable years shall be determined and assessed by the Commissioner within four years after the return was filed, and the amount of any such taxes due under any return made under this Act for prior taxable years or under prior income, excess-profits, or war-profits tax Acts, or under section 38 of the Act entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," approved August 5, 1909, shall be determined and assessed within five years after the return was filed, unless both the Commissioner and the taxpayer consent in writing to a later determination, assessment, and collection of the tax; and no suit or proceeding for the collection of any such taxes due under this Act or under prior income, excess-profits, or war-profits tax Acts, or of any taxes due under section 38 of such Act of August 5, 1909,

shall be begun, after the expiration of five years after the date when such return was filed, but this shall not affect suits or proceedings begun at the time of the passage of this Act: *Provided*, That in the case of income received during the lifetime of a decedent, all taxes due thereon shall be determined and assessed by the Commissioner within one year after written request therefor by the executor, administrator, or other fiduciary representing the estate of such decedent: *Provided further*, That in the case of a false or fraudulent return with intent to evade tax, or of a failure to file a required return, the amount of tax due may be determined, assessed, and collected, and a suit or proceeding for the collection of such amount may be begun, at any time after it becomes due: *Provided further*, That in cases coming within the scope of paragraph (9) of subdivision (a) of section 214, or of paragraph (8) of subdivision (a) of section 234, or in cases of final settlement of losses and other deductions tentatively allowed by the Commissioner pending a determination of the exact amount deductible, the amount of tax or deficiency in tax due may be determined, assessed, and collected at any time; but prior to the assessment thereof the taxpayer shall be notified and given a period of not less than thirty days in which to file an appeal and be heard as hereinafter provided in this subdivision.

If upon examination of a return made under the Revenue Act of 1916, the Revenue Act of 1917, the Revenue Act of 1918, or this Act, a tax or a deficiency in tax is discovered, the taxpayer shall be notified thereof and given a period of not less than thirty days after such notice is sent by registered mail in which to file an appeal and show cause or reason why the tax or deficiency should not be paid. Opportunity for hearing shall be granted and a final decision thereon shall be made as quickly as practicable. Any tax or deficiency in tax then determined to be due shall be assessed and paid, together with the penalty and interest, if any, applicable thereto, within ten days after notice and demand by the collector as hereinafter provided, and in such cases no claim in abatement of the amount so assessed shall be entertained: *Provided*, That in cases where the Commissioner believes that the collection of the amount due will be jeopardized by such delay he may make the assessment without giving such notice or awaiting the conclusion of such hearing.

(e) If any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, then, except in the case of estates of insane, deceased, or insolvent persons, there shall be added as part of the tax the sum of 5 per centum on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time it became due: *Provided*, That as to any such amount which is the subject of a bona fide claim for abatement filed within ten days after notice and demand by the collector, where the taxpayer has not had the benefit of the provisions of subdivision (d), such sum of 5 per centum shall not be added and the interest from the time the amount was due until

the claim is decided shall be at the rate of one-half of 1 per centum per month on that part of the claim rejected.

In the case of the first installment provided for in subdivision (a) the instructions printed on the return shall be sufficient notice of the date when the tax is due and sufficient demand, and the taxpayer's computation of the tax on the return shall be sufficient notice of the amount due. In the case of each subsequent installment the collector may, within thirty days and not later than ten days before the installment becomes due, mail to the taxpayer notice of the amount of the installment and the date on which it is due for payment. Such notice of the collector shall be sufficient notice and sufficient demand under this section.

(f) In the case of any deficiency (except where the deficiency is due to negligence or to fraud with intent to evade tax) where it is shown to the satisfaction of the Commissioner that the payment of such deficiency would result in undue hardship to the taxpayer, the Commissioner may, with the approval of the Secretary, extend the time for the payment of such deficiency or any part thereof for such period not in excess of eighteen months from the passage of this Act as the Commissioner may determine. In such case the Commissioner may require the taxpayer to furnish a bond with sufficient sureties conditioned upon the payment of the deficiency in accordance with the terms of the extension granted, there shall be added in lieu of other interest provided by law, as a part of such deficiency, interest thereon at the rate of two-thirds of 1 per centum per month from the time such extension is granted; except where such other interest provided by law is in excess of interest at the rate of two-thirds of 1 per centum per month. If the deficiency or any part thereof is not paid in accordance with the terms of the extension granted, there shall be added as part of the deficiency, in lieu of other interest and penalties provided by law, the sum of 5 per centum of the deficiency and interest on the deficiency at the rate of 1 per centum per month from the time it becomes payable in accordance with the terms of such extension.

(g) If the Commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be brought without delay, the Commissioner shall declare the taxable period for such taxpayer immediately terminated and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In any action or suit brought to enforce payment of taxes made due and payable by virtue of the provisions of this subdivision the finding of

the Commissioner, made as herein provided, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design. A taxpayer who is not in default in making any return or paying income, war-profits, or excess-profits tax under any Act of Congress may furnish to the United States, under regulations to be prescribed by the Commissioner with the approval of the Secretary, security approved by the Commissioner that he will duly make the return next thereafter required to be filed and pay the tax next thereafter required to be paid. The Commissioner may approve and accept in like manner security for return and payment of taxes made due and payable by virtue of the provisions of this subdivision, provided the taxpayer has paid in full all other income, war-profits, or excess-profits taxes due from him under any Act of Congress. If security is approved and accepted pursuant to the provisions of this subdivision and such further or other security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment of such taxes shall not be enforced by any proceedings under the provisions of this subdivision prior to the expiration of the time otherwise allowed for paying such respective taxes. In the case of a citizen of the United States about to depart from the United States the Commissioner may, at his discretion, waive any or all of the requirements placed on the taxpayer by this subdivision. No alien shall depart from the United States unless he first secures from the collector or agent in charge a certificate that he has complied with all the obligations imposed upon him by the income, war-profits, and excess-profits tax laws. If a taxpayer violates or attempts to violate this subdivision there shall, in addition to all other penalties, be added as part of the tax 25 per centum of the total amount of the tax or deficiency in the tax, together with interest at the rate of 1 per centum per month from the time the tax became due.

(h) The provisions of subdivisions (e), (f) and (g) of this section shall apply to the assessment and collection of taxes which have accrued or may accrue under the Revenue Act of 1917, the Revenue Act of 1918 or this Act.

Receipts for Taxes

SEC. 251. That every collector to whom any payment of any tax is made under the provisions of this title shall upon request give to the person making such payment a full written or printed receipt, stating the amount paid and the particular account for which such payment was made; and whenever any debtor pays taxes on account of payments made or to be made by him to separate creditors the collector shall, if requested by such debtor, give a separate receipt for the tax paid on account of each creditor in such form that the debtor can conveniently produce such receipts separately to his several creditors in satisfaction of their respective demands up to the amounts stated in the receipts; and such receipts shall be sufficient evidence in favor of such debtor to justify him in withholding

from his next payment to his creditor the amount therein stated; but the creditor may, upon giving to his debtor a full written receipt acknowledging the payment to him of any sum actually paid and accepting the amount of tax paid as aforesaid (specifying the same) as a further satisfaction of the debt to that amount, require the surrender to him of such collector's receipt.

Refunds

SEC. 252. That if, upon examination of any return of income made pursuant to this Act, the Act of August 5, 1909, entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," the Act of October 3, 1913, entitled "An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes," the Revenue Act of 1916, as amended, the Revenue Act of 1917, or the Revenue Act of 1918, it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of section 3228 of the Revised Statutes, the amount of the excess shall be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from the taxpayer under any other return, and any balance of such excess shall be immediately refunded to the taxpayer: *Provided,* That no such credit or refund shall be allowed or made after five years from the date when the return was due, unless before the expiration of such five years a claim therefor is filed by the taxpayer: *Provided further,* That if upon examination of any return of income made pursuant to the Revenue Act of 1917, the Revenue Act of 1918, or this Act, the invested capital of a taxpayer is decreased by the Commissioner, and such decrease is due to the fact that the taxpayer failed to take adequate deductions in previous years, with the result that an amount of income tax in excess of that properly due was paid in any previous year or years, then, notwithstanding any other provision of law and regardless of the expiration of such five-year period, the amount of such excess shall, without the filing of any claim therefor, be credited or refunded as provided in this section: *And provided further,* That nothing in this section shall be construed to bar from allowance claims for refund filed prior to the passage of the Revenue Act of 1918 under subdivision (a) of section 14 of the Revenue Act of 1916, or filed prior to the passage of this Act under section 252 of the Revenue Act of 1918.

Penalties

Sec. 253. That any individual, corporation, or partnership required under this title to pay or collect any tax, to make a return or to supply information, who fails to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, shall be liable to a penalty of not more than $1,000. Any individual, corporation, or partnership, or any officer or employee of any corporation or

member or employee of a partnership, who willfully refuses to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, or who willfully attempts in any manner to defeat or evade the tax imposed by this title, shall be guilty of a misdemeanor and shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

Returns of Payments of Dividends

SEC. 254. That every corporation subject to the tax imposed by this title and every personal service corporation shall, when required by the Commissioner, render a correct return, duly verified under oath, of its payments of dividends, stating the name and address of each stockholder, the number of shares owned by him, and the amount of dividends paid to him.

Returns of Brokers

SEC. 255. That every individual, corporation, or partnership doing business as a broker shall, when required by the Commissioner, render a correct return duly verified under oath, under such rules and regulations as the Commissioner, with the approval of the Secretary, may prescribe, showing the names of customers for whom such individual, corporation, or partnership has transacted any business, with such details as to the profits, losses, or other information which the Commissioner may require, as to each of such customers, as will enable the Commissioner to determine whether all income tax due on profits or gains of such customers has been paid.

Information at Source

SEC. 256. That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, and employers, making payment to another individual, corporation, or partnership, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments or other fixed or determinable gains, profits, and income (other than payments described in sections 254 and 255), of $1,000 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Commissioner, under such regulations and in such form and manner and to such extent as may be prescribed by him with the approval of the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

Such returns may be required, regardless of amounts, (1) in the case of payments of interest upon bonds, mortgages, deeds of trust, or other

similar obligations of corporations, and (2) in the case of collections of items (not payable in the United States) of interest upon the bonds of foreign countries and interest upon the bonds of and dividends from foreign corporations by individuals, corporations, or partnerships, undertaking as a matter of business or for profit the collection of foreign payments of such interest or dividends by means of coupons, checks, or bills of exchange.

When necessary to make effective the provisions of this section the name and address of the recipient of income shall be furnished upon demand of the individual, corporation, or partnership paying the income.

The provisions of this section shall apply to the calendar year 1921 and each calendar year thereafter, but shall not apply to the payment of interest on obligations of the United States.

Returns to Be Public Records

Sec. 257. That returns upon which the tax has been determined by the Commissioner shall constitute public records; but they shall be open to inspection only upon order of the President and under rules and regulations prescribed by the Secretary and approved by the President: *Provided,* That the proper officers of any State imposing an income tax may, upon the request of the governor thereof, have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the Secretary may prescribe: *Provided further,* That all bona fide stockholders of record owning 1 per centum or more of the outstanding stock of any corporation shall, upon making request of the Commissioner, be allowed to examine the annual income returns of such corporation and of its subsidiaries. Any stockholder who pursuant to the provisions of this section is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return, shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000, or by imprisonment not exceeding one year, or both.

The Commissioner shall as soon as practicable in each year cause to be prepared and made available to public inspection in such manner as he may determine, in the office of the collector in each internal-revenue district and in such other places as he may determine, lists containing the names and the post-office addresses of all individuals making income-tax returns in such district.

Publication of Statistics

Sec. 258. That the Commissioner, with the approval of the Secretary, shall prepare and publish annually statistics reasonably available with respect to the operation of the income, war-profits and excess-profits tax laws, including classifications of taxpayers and of income, the amounts

allowed as deductions, exemptions, and credits, and any other facts deemed pertinent and valuable.

Collection of Foreign Items

SEC. 259. That all individuals, corporations, or partnerships undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks, or bills of exchange shall obtain a license from the Commissioner and shall be subject to such regulations enabling the Government to obtain the information required under this title as the Commissioner, with the approval of the Secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both.

Citizens of Possessions of the United States

SEC. 260. That any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States, shall be subject to taxation under this title only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources.

Nothing in this section shall be construed to alter or amend the provisions of the Act entitled "An Act making appropriations for the naval service for the fiscal year ending June 30, 1922, and for other purposes," approved July 12, 1921, relating to the imposition of income taxes in the Virgin Islands of the United States.

Porto Rico and Philippine Islands

SEC. 261. That in Porto Rico and the Philippine Islands the income tax shall be levied, assessed, collected, and paid as provided by law prior to the passage of this Act.

The Porto Rican or Philippine Legislature shall have power by due enactment to amend, alter, modify, or repeal the income tax laws in force in Porto Rico or the Philippine Islands, respectively.

Income from Sources Within the Possessions of the United States

SEC. 262. (a) That in the case of citizens of the United States or domestic corporations, satisfying the following conditions, gross income means only gross income from sources within the United States—

(1) If 80 per centum or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section) for the three-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

(2) If, in the case of such corporation, 50 per centum or more of its gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States; or

(3) If, in the case of such citizen, 50 per centum or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another.

(b) Notwithstanding the provisions of subdivision (a) there shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.

(c) As used in this section the term "possession of the United States" does not include the Virgin Islands of the United States.

Effective Date of Title

SEC. 263. That this title shall take effect as of January 1, 1921.

SEC. 264. (a) That for the purpose only of the tax imposed by section 230 there shall be allowed, in the case of a corporation organized under the China Trade Act, 1922, a credit of an amount equal to the proportion of the net income derived from sources within China (determined in a similar manner to that provided in section 217) which the par value of the shares of stock of the corporation owned on the last day of the taxable year by individual citizens of the United States or China, resident in China, bears to the par value of the whole number of shares of stock of the corporation outstanding on such date:

Provided, That in no case shall the amount by which the tax imposed by section 230 is diminished by reason of such credit exceed the amount of the special dividend certified under subdivision (b) of this section.

(b) Such credit shall not be allowed unless the Secretary of Commerce has certified to the Commissioner

(1) The amount which, during the year ending on the date of filing the return, the corporation has distributed as a special dividend to or for the benefit of such individuals as on the last day of the taxable year were citizens of the United States or China, resident in China, and owned shares of stock of the corporation,

(2) That such special dividend was in addition to all other amounts, payable or to be payable to such individuals or for their benefit, by reason of their interest in the corporation, and

(3) That such distribution has been made to or for the benefit of such individuals in proportion to the par value of the shares of stock of the corporation owned by each;

Except that if the corporation has more than one class of stock, the certificate shall contain a statement that the articles of incorpora-

tion provide a method for the apportionment of such special dividend among such individuals, and that the amount certified has been distributed in accordance with the method so provided.

(c) For the purpose of this section shares of stock of a corporation shall be considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

(d) As used in the section the term "China" shall have the same meaning as when used in the China Trade Act, 1922.

TITLE III.—WAR-PROFITS AND EXCESS-PROFITS TAX FOR 1921.

Part I.—General Definitions.

Sec. 300. That when used in this title the terms "taxable year," "fiscal year," "personal service corporation," "paid or accrued," and "dividends" shall have the same meaning as provided for the purposes of income tax in sections 200 and 201.

Part II.—Imposition of Tax

Sec. 301. (a) That in lieu of the tax imposed by Title III of the Revenue Act of 1918, but in addition to the other taxes imposed by this Act, there shall be levied, collected and paid for the calendar year 1921 upon the net income of every corporation (except corporations taxable under subdivision (b) of this section) a tax equal to the sum of the following:

First Bracket

20 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital.

Second Bracket

40 per centum of the amount of the net income in excess of 20 per per centum of the invested capital.

(b) For the calendar year 1921 there shall be levied, collected, and paid upon the net income of every corporation which derives in such year a net income of more than $10,000 from any Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, a tax equal to the sum of the following:

(1) Such a portion of a tax computed at the rates specified in subdivision (a) of section 301 of the Revenue Act of 1918, as the part of the net income attributable to such Government contract or contracts bears to the entire net income. In computing such tax the excess-profits credit and the war-profits credit which would be applicable to such calendar year under the Revenue Act of 1918 if it had been continued in force, shall be used;

(2) Such a portion of a tax computed at the rates specified in subdivision (a) of this section as the part of the net income not attributable to such Government contract or contracts bears to the entire net income.

For the purpose of determining the part of the net income attributable to such Government contract or contracts, the proper apportionment and allocation of the deductions with respect to gross income derived from such Government contract or contracts and from other sources, respectively, shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

(c) In any case where the full amount of the excess-profits credit is not allowed under the first bracket of subdivision (a), by reason of the fact that such credit is in excess of 20 per centum of the invested capital, the part not so allowed shall be deducted from the amount in the second bracket.

SEC. 302. That the tax imposed by subdivision (a) of section 301 shall in no case be more than 20 per centum of the amount of the net income in excess of $3,000 and not in excess of $20,000, plus 40 per centum of the amount of the net income in excess of $20,000; and the limitations imposed by section 302 of the Revenue Act of 1918 (upon taxes computed under subdivision (c) of section 301 of that Act) are hereby made applicable to taxes computed under subdivision (b) of section 301 of this Act. Nothing in this section shall be construed in such manner as to increase the tax imposed by section 301 of this Act.

SEC. 303. That if part of the net income of a corporation is derived (1) from a trade or business (or a branch of a trade or business) in which the employment of capital is necessary, and (2) a part (constituting not less than 30 per centum of its total net income) is derived from a separate trade or business (or a distinctly separate branch of the trade or business) which if constituting the sole trade or business would bring it within the class of "personal service corporations," then (under regulations prescribed by the Commissioner with the approval of the Secretary) the tax upon the first part of such net income shall be separately computed (allowing in such computation only the same proportionate part of the credits authorized in section 312), and the tax upon the second part shall be the same percentage thereof as the tax so computed upon the first part is of such first part: *Provided,* That the tax upon such second part shall in no case be less than 20 per centum thereof, unless the tax upon the entire net income, if computed without benefit of this section, would constitute less than 20 per centum of such entire net income, in which event the tax shall be determined upon the entire net income, without reference to this section, as other taxes are determined under this title. The total tax computed under this section shall be subject to the limitations provided in section 302.

SEC. 304. (a) That the corporations enumerated in section 231 shall, to the extent that they are exempt from income tax under Title II, be exempt from taxation under this title.

(b) Any corporation whose net income for the taxable year is less than $3,000 shall be exempt from taxation under this title.

(c) In the case of any corporation engaged in the mining of gold, the portion of the net income derived from the mining of gold shall be exempt from the tax imposed by this title or any tax imposed by Title II of the Revenue Act of 1917, and the tax on the remaining portion of the net income shall be the same proportion of a tax computed without the benefit of this subdivision which such remaining portion of the net income bears to the entire net income.

SEC. 305. That if a tax is computed under this title for a period of less than twelve months, the specific exemption of $3,000, wherever referred to in this title, shall be reduced to an amount which is the same proportion of $3,000 as the number of months in the period is of twelve months.

PART III.—EXCESS-PROFITS CREDIT.

SEC. 312. That the excess-profits credit shall consist of a specific exemption of $3,000 plus an amount equal to 8 per centum of the invested capital for the taxable year.

A foreign corporation or a corporation entitled to the benefits of section 262 shall not be entitled to the specific exemption of $3,000.

PART IV.—NET INCOME.

SEC. 320. That for the purpose of this title the net income of a corporation shall be ascertained and returned for the taxable year upon the same basis and in the same manner as provided for income tax purposes in Title II of this Act.

PART V.—INVESTED CAPITAL.

SEC. 325. (a) That as used in this title—

The term "intangible property" means patents, copyrights, secret processes and formulae, good will, trade-marks, trade-brands, franchises, and other like property;

The term "tangible property" means stocks, bonds, notes, and other evidences of indebtedness, bills and accounts receivable, leaseholds, and other property other than intangible property;

The term "borrowed capital" means money or other property borrowed, whether represented by bonds, notes, open accounts, or otherwise;

The term "inadmissible assets" means stocks, bonds, and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income, but where the income derived from such assets consists in part of gain or profit derived from the sale or other disposition thereof, or where all or part of the

interest derived from such assets is in effect included in the net income because of the limitation on the deduction of interest under paragraph (2) of subdivision (a) of section 234, a corresponding part of the capital invested in such assets shall not be deemed to be inadmissible assets;

The term "admissible assets" means all assets other than inadmissible assets, valued in accordance with the provisions of subdivision (a) of section 326 and section 331.

(b) For the purposes of this title the par value of stock or shares shall, in the case of stock or shares issued at a nominal value or having no par value, be deemed to be the fair market value as of the date or dates of issue of such stock or shares.

SEC. 326. (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivision (b) and (c) of this section):

(1) Actual cash bona fide paid in for stock or shares;

(2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the Commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: *Provided*, That the Commissioner shall keep a record of all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor, and the amount included under this paragraph as paid-in surplus. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257;

(3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;

(4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest;

(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest; *Provided*, That no

case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; but

(b) As used in this title the term "invested capital" does not include borrowed capital.

(c) There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year.

(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall be the same fractional part of such average invested capital.

SEC. 327. That in the following cases the tax shall be determined as provided in section 328:

(a) Where the Commissioner is unable to determine the invested capital as provided in section 326;

(b) In the case of a foreign corporation or of a corporation entitled to the benefits of section 262;

(c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively;

(d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital, nor (2) in which 50 per centum or more of the gross income of the corporation for the taxable year (computed under section 233 of Title II) consists of gains, profits, commissions, or other income, derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

SEC. 328. (a) That in the cases specified in section 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for such year. In the case of a foreign corporation or of a corporation entitled to the benefits of section 262

the tax shall be computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.

In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amounts and rate of war profits or excess profits, and all other relevant facts and circumstances.

(b) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.

(c) The Commissioner shall keep a record of all cases in which the tax is determined in the manner prescribed in subdivision (a), containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, and the amount of invested capital as determined under such subdivision. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257.

PART VI.—REORGANIZATIONS.

SEC. 331. That in the case of the reorganization, consolidation, or change of ownership of a trade or business, or change of ownership of property, after March 3, 1917, if an interest or control in such trade or business or property of 50 per centum or more remains in the same persons, or any of them, then no asset transferred or received from the previous owner shall, for the purpose of determining invested capital, be allowed a greater value than would have been allowed under this title in computing the invested capital of such previous owner if such asset had not been so transferred or received: *Provided,* That if such previous owner was not a corporation, then the value of any asset so transferred or received shall be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, betterment or development, but no addition to the original cost shall be made for any charge or expenditure deducted as expense or otherwise on or after March 1, 1913, in computing the net income of such previous owner for purposes of taxation.

PART VII.—MISCELLANEOUS.

SEC. 335. (a) That if a corporation (other than a personal service corporation) makes return for a fiscal year beginning in 1920 and ending

in 1921, the war-profits and excess-profits tax for the taxable year 1921 shall be the sum of: (1) the same proportion of a tax for the entire period computed under the Revenue Act of 1918, which the portion of such period falling within the calendar year 1920 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title, which the portion of such period falling within the calendar year 1921 is of the entire period. Any amount heretofore or hereafter paid on account of the tax imposed for such taxable year by the Revenue Act of 1918 shall be credited towards the payment of the tax as above computed, and if the amount so paid exceeds the amount of such tax, the excess shall be credited or refunded to the corporation in accordance with the provisions of section 252 of this Act.

(b) If a corporation (other than a personal service corporation) makes a return for a fiscal year beginning in 1921 and ending in 1922, the war-profits and excess-profits tax for the portion of the year falling within the calendar year 1921 shall be an amount equivalent to the same proportion of a tax for the entire period computed under this title, which the portion of such period falling within the calendar year 1921 is of the entire period.

SEC. 336. That every corporation, not exempt under section 304, shall make a return for the purposes of this title. Such returns shall be made, and the taxes imposed by this title shall be paid, at the same times and places, in the same manner, and subject to the same conditions, as is provided in the case of returns and payment of income tax by corporations for the purposes of Title II, and all the provisions of that title not inapplicable, including penalties, are hereby made applicable to the taxes imposed by this title.

SEC. 337. That in the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the prinicipal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this title attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest.

Effective Date of Title

SEC. 338. That this title shall take effect as of January 1, 1921.

TITLE IV.—ESTATE TAX.

SEC. 400. That when used in this title—

The term "executor" means the executor or administrator of the decedent, or, if there is no executor or administrator, any person in actual or constructive possession of any property of the decedent;

The term "net estate" means the net estate as determined under the provisions of section 403;

The term "month" means calendar month; and

The term "collector" means the collector of internal revenue of the district in which was the domicile of the decedent at the time of his death, or, if there was no such domicile in the United States, then the collector of the district in which is situated the part of the gross estate of the decedent in the United States, or, if such part of the gross estate is situated in more than one district, then the collector of internal revenue of such district as may be designated by the Commissioner.

SEC. 401. That, in lieu of the tax imposed by Title IV of the Revenue Act of 1918, a tax equal to the sum of the following percentages of the value of the net estate (determined as provided in section 403) is hereby imposed upon the transfer of the net estate of every decedent dying after the passage of this Act, whether a resident or nonresident of the United States:

1 per centum of the amount of the net estate not in excess of $50,000;

2 per centum of the amount by which the net estate exceeds $50,000 and does not exceed $150,000;

3 per centum of the amount by which the net estate exceeds $150,000 and does not exceed $250,000;

4 per centum of the amount by which the net estate exceeds $250,000 and does not exceed $450,000;

6 per centum of the amount by which the net estate exceeds $450,000 and does not exceed $750,000;

8 per centum of the amount by which the net estate exceeds $750,000 and does not exceed $1,000,000;

10 per centum of the amount by which the net estate exceeds $1,000,000 and does not exceed $1,500,000;

12 per centum of the amount by which the net estate exceeds $1,500,000 and does not exceed $2,000,000;

14 per centum of the amount by which the net estate exceeds $2,000,000 and does not exceed $3,000,000;

16 per centum of the amount by which the net estate exceeds $3,000,000 and does not exceed $4,000,000;

18 per centum of the amount by which the net estate exceeds $4,000,000 and does not exceed $5,000,000;

20 per centum of the amount by which the net estate exceeds $5,000,000 and does not exceed $8,000,000;

22 per centum of the amount by which the net estate exceeds $8,000,000 and does not exceed $10,000,000; and

25 per centum of the amount by which the net estate exceeds $10,000,000.

The taxes imposed by this title or by Title II of the Revenue Act of 1916 (as amended by the Act entitled "An Act to provide increased revenue to defray the expenses of the increased appropriations for the Army and Navy and the extensions of fortifications, and for other purposes," approved March 3, 1917) or by Title IX of the Revenue Act of 1917, or by Title IV of the Revenue Act of 1918, shall not apply to the transfer of the net estate of any decedent who has died or may die from injuries received

or disease contracted in line of duty while serving in the military or naval forces of the United States in the war against the German Government, or to the transfer of the net estate of any citizen of the United States who has died or may die from injuries received or disease contracted in line of duty while serving in the military or naval forces of any country while associated with the United States in the prosecution of such war, or prior to the entrance therein of the United States, and any tax collected upon such transfer shall be refunded to the estate of such decedent.

SEC. 402. That the value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated—

(a) To the extent of the interest therein of the decedent at the time of his death which after his death is subject to the payment of the charges against his estate and the expenses of its administration and is subject to distribution as part of his estate;

(b) To the extent of any interest therein of the surviving spouse, existing at the time of the decedent's death as dower, curtesy, or by virtue of a statute creating an estate in lieu of dower or curtesy;

(c) To the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has at any time created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death (whether such transfer or trust is made or created before or after the passage of this Act), except in case of a bona fide sale for a fair consideration in money or money's worth. Any transfer of a material part of his property in the nature of a final disposition or distribution thereof, made by the decedent within two years prior to his death without such a consideration, shall, unless shown to the contrary, be deemed to have been made in contemplation of death within the meaning of this title;

(d) To the extent of the interest therein held jointly or as tenants in the entirety by the decedent and any other person, or deposited in banks or other institutions in their joint names and payable to either or the survivor, except such part thereof as may be shown to have originally belonged to such other person and never to have been received or acquired by the latter from the decedent for less than a fair consideration in money or money's worth: *Provided,* That where such property or any part thereof, or part of the consideration with which such property was acquired, is shown to have been at any time acquired by such other person from the decedent for less than a fair consideration in money or money's worth, there shall be excepted only such part of the value of such property as is proportionate to the consideration furnished by such other person: *Provided further,* That where any property has been acquired by gift, bequest, devise, or inheritance, as a tenancy in the entirety by the decedent and spouse, or where so acquired by the decedent and any other person as joint tenants and their interests are not otherwise specified or fixed by law, then to the extent of one-half of the value thereof;

(e) To the extent of any property passing under a general power of appointment exercised by the decedent (1) by will, or (2) by deed executed in contemplation of, or intended to take effect in possession or enjoyment at or after, his death, except in case of a bona fide sale for a fair consideration in money or money's worth; and

(f) To the extent of the amount receivable by the executor as insurance under policies taken out by the decedent upon his own life; and to the extent of the excess over $40,000 of the amount receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life.

SEC. 403. That for the purpose of the tax the value of the net estate shall be determined—

(a) In the case of a resident, by deducting from the value of the gross estate—

(1) Such amounts for funeral expenses, administration expenses, claims against the estate, unpaid mortgages upon, or any indebtedness in respect to, property (except, in the case of a resident decedent, where such property is not situated in the United States), losses incurred during the settlement of the estate arising from fires, storms, shipwreck, or other casualty, or from theft, when such losses are not compensated for by insurance or otherwise, and such amounts reasonably required and actually expended for the support during the settlement of the estate of those dependent upon the decedent, as are allowed by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered, but not including any income taxes upon income received after the death of the decedent, or any estate, succession, legacy, or inheritance taxes;

(2) An amount equal to the value of any property forming a part of the gross estate situated in the United States of any person who died within five years prior to the death of the decedent where such property can be identified as having been received by the decedent from such prior decedent by gift, bequest, devise, or inheritance, or which can be identified as having been acquired in exchange for property so received: *Provided,* That this deduction shall be allowed only where an estate tax under this or any prior Act of Congress was paid by or on behalf of the estate of such prior decedent, and only in the amount of the value placed by the Commissioner on such property in determining the value of the gross estate of such prior decedent, and only to the extent that the value of such property is included in the decedent's gross estate and not deducted under paragraphs (1) or (3) of subdivision (a) of this section. This deduction shall be made in case of the estates of all decedents who have died since September 8, 1916;

(3) The amount of all bequests, legacies, devices, or transfers, except bona fide sales for a fair consideration in money or money's worth, in contemplation of or intended to take effect in possession or enjoyment at or after the decedent's death, to or for the use of the United States, any

State, Territory, any political subdivision thereof, or the District of Columbia, for exclusively public purposes, or to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, or to a trustee or trustees exclusively for such religious, charitable, scientific, literary, or educational purposes. This deduction shall be made in case of the estates of all decedents who have died since December 31, 1917; and

(4) An exemption of $50,000;

(b) In the case of a nonresident, by deducting from the value of that part of his gross estate which at the time of his death is situated in the United States—

(1) That proportion of the deductions specified in paragraph (1) of subdivision (a) of this section which the value of such part bears to the value of his entire gross estate, wherever situated, but in no case shall the amount so deducted exceed 10 per centum of the value of that part of his gross estate which at the time of his death is situated in the United States;

(2) An amount equal to the value of any property forming a part of the gross estate situated in the United States of any person who died within five years prior to the death of the decedent where such property can be identified as having been received by the decedent from such prior decedent by gift, bequest, devise, or inheritance, or which can be identified as having been acquired in exchange for property so received: *Provided*, That this deduction shall be allowed only where an estate tax under this or any prior Act of Congress was paid by or on behalf of the estate of such prior decedent, and only in the amount of the value placed by the Commissioner on such property in determining the value of the gross estate of such prior decedent, and only to the extent that the value of such property is included in that part of the decedent's gross estate which at the time of his death is situated in the United States and not deducted under paragraphs (1) or (3) of subdivision (b) of this section. This deduction shall be made in case of the estates of all decedents who have died since September 8, 1916; and

(3) The amount of all bequests, legacies, devises or transfers, except bona fide sales for a fair consideration, in money, or money's worth, in contemplation of or intended to take effect in possession or enjoyment at or after the decedent's death, to or for the use of the United States, any State, Territory, any political subdivision thereof, or the District of Columbia, for exclusively public purposes, or to or for the use of any domestic corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art and the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual, or to a trustee or trustees exclusively for such religious,

charitable, scientific, literary, or educational purposes within the United States. This deduction shall be made in case of the estates of all decedents who have died since December 31, 1917.

No deduction shall be allowed in the case of a nonresident unless the executor includes in the return required to be filed under section 404 the value at the time of his death of that part of the gross estate of the nonresident not situated in the United States.

For the purpose of this title stock in a domestic corporation owned and held by a nonresident decedent shall be deemed property within the United States, and any property of which the decedent has made a transfer or with respect to which he has created a trust, within the meaning of subdivision (c) of section 402, shall be deemed to be situated in the United States, if so situated either at the time of the transfer or the creation of the trust, or at the time of the decedent's death.

The amount receivable as insurance upon the life of a nonresident decedent, and any moneys deposited with any person carrying on the banking business, by or for a nonresident decedent who was not engaged in business in the United States at the time of his death, shall not, for the purpose of this title, be deemed property within the United States.

Missionaries duly commissioned and serving under boards of foreign missions of the various religious denominations in the United States, dying while in the foreign missionary service of such boards, shall not, by reason merely of their intention to permanently remain in such foreign service, be deemed nonresidents of the United States, but shall be presumed to be residents of the State, the District of Columbia, or the Territories of Alaska or Hawaii wherein they respectively resided at the time of their commission and their departure for such foreign service.

In the case of any estate in respect to which the tax has been paid, if necessary to allow the benefit of the deduction under paragraphs (2) and (3) of subdivision (a) or (b) the tax shall be redetermined and any excess of tax paid shall be refunded to the executor.

Sec. 404. That the executor, within two months after the decedent's death, or within a like period after qualifying as such, shall give written notice thereof to the collector. The executor shall also, at such times and in such manner as may be required by regulations made pursuant to law, file with the collector a return under oath in duplicate, setting forth (a) the value of the gross estate of the decedent at the time of his death, or in case of a nonresident, of that part of his gross estate situated in the United States; (b) the deductions allowed under section 403; (c) the value of the net estate of the decedent as defined in section 403; and (d) the tax paid or payable thereon; or such part of such information as may at the time be ascertainable and such supplemental data as may be necessary to establish the correct tax.

Returns shall be made in all cases where the gross estate at the death of the decedent exceeds $50,000, and in the case of the estate of every nonresident any part of whose gross estate is situated in the United States.

If the executor is unable to make a complete return as to any part of the gross estate of the decedent, he shall include in his return a description of such part and the name of every person holding a legal or beneficial interest therein, and upon notice from the collector such person shall in like manner make a return as to such part of the gross estate. The Commissioner shall make all assessments of the tax under the authority of existing administrative special and general provisions of law relating to the assessment and collection of taxes.

SEC. 405. That if no administration is granted upon the estate of a decedent, or if no return is filed as provided in section 404, or if a return contains a false or incorrect statement of a material fact, the collector or deputy collector shall make a return and the Commissioner shall assess the tax thereon.

SEC. 406. That the tax shall be due and payable one year after the decedent's death; but in any case where the Commissioner finds that payment of the tax within such period would impose undue hardship upon the estate, he may grant an extension or extensions of time for payment not to exceed three years from the due date.

The executor shall pay the tax to the collector or deputy collector, and to such portion of the tax, not paid within one year and six months after the decedent's death, interest at the rate of 6 per centum per annum from the expiration of one year after such death shall be added as part of the tax irrespective of any extension or extensions of time that may have been granted for the payment of the tax, or any portion thereof.

SEC. 407. That where the amount of tax shown upon a return made in good faith has been fully paid, or time for payment has been extended, as provided in section 406, beyond one year and six months after the decedent's death, and an additional amount of tax is, after the expiration of such period of one year and six months, found to be due, then such additional amount shall be paid upon notice and demand by the collector, and if it remains unpaid for one month after such notice and demand there shall be added as part of the tax interest on such additional amount at the rate of 10 per centum per annum from the expiration of such period until paid, and such additional tax and interest shall, until paid, be and remain a lien upon the entire gross estate.

The collector shall grant to the person paying the tax duplicate receipts, either of which shall be sufficient evidence of such payment, and shall entitle the executor to be credited and allowed the amount thereof by any court having jurisdiction to audit or settle his accounts.

If the executor files a complete return and makes written application to the Commissioner for determination of the amount of the tax and discharge from personal liability therefor, the Commissioner, as soon as possible and in any event within one year after receipt of such application, shall notify the executor of the amount of the tax, and upon payment thereof the executor shall be discharged from personal liability for any

additional tax thereafter found to be due, and shall be entitled to receive a receipt or writing showing such discharge: *Provided, however,* That such discharge shall not operate to release the gross estate from the lien of any additional tax that may hereafter be found to be due while the title to such gross estate remains in the heirs, devisees, or distributees thereof; but no part of such gross estate shall be subject to such lien or to any claim or demand for any such tax if the title thereto has passed to a bona fide purchaser for value.

Sec. 408. That if the tax herein imposed is not paid on or before the due date thereof the collector shall, upon instruction from the Commissioner, proceed to collect the tax under the provisions of general law, or commence appropriate proceedings in any court of the United States, in the name of the United States, to subject the property of the decedent to be sold under the judgment or decree of the court. From the proceeds of such sale the amount of the tax, together with the costs and expenses of every description to be allowed by the court, shall be first paid, and the balance shall be deposited according to the order of the court, to be paid under its direction to the person entitled thereto.

If the tax or any part thereof is paid by, or collected out of that part of the estate passing to or in the possession of, any person other than the executor in his capacity as such, such person shall be entitled to reimbursement out of any part of the estate still undistributed or by a just and equitable contribution by the persons whose interest in the estate of the decedent would have been reduced if the tax had been paid before the distribution of the estate or whose interest is subject to equal or prior liability for the payment of taxes, debts, or other charges against the estate, it being the purpose and intent of this title that so far as is practicable and unless otherwise directed by the will of the decedent the tax shall be paid out of the estate before its distribution. If any part of the gross estate consists of proceeds of policies of insurance upon the life of the decedent receivable by a beneficiary other than the executor, the executor shall be entitled to recover from such beneficiary such portion of the total tax paid as the proceeds, in excess of $40,000, of such policies bear to the net estate. If there is more than one such beneficiary the executor shall be entitled to recover from such beneficiaries in the same ratio.

Sec. 409. That unless the tax is sooner paid in full, it shall be a lien for ten years upon the gross estate of the decedent, except that such part of the gross estate as is used for the payment of charges against the estate and expenses of its administration, allowed by any court having jurisdiction thereof, shall be divested of such lien. If the Commissioner is satisfied that the tax liability of an estate has been fully discharged or provided for, he may, under regulations prescribed by him with the approval of the Secretary, issue his certificate, releasing any or all property of such estate from the lien herein imposed.

If (a) the decedent makes a transfer of, or creates a trust with re-

spect to, any property in contemplation of or intended to take effect in possession or enjoyment at or after his death (except in the case of a bona fide sale for a fair consideration in money or money's worth) or (b) if insurance passes under a contract executed by the decedent in favor of a specific beneficiary, and if in either case the tax in respect thereto is not paid when due, then the transferee, trustee, or beneficiary shall be personally liable for such tax, and such property, to the extent of the decedent's interest therein at the time of such transfer, or to the extent of such beneficiary's interest under such contract of insurance, shall be subject to a like lien equal to the amount of such tax. Any part of such property sold by such transferee or trustee to a bona fide purchaser for a fair consideration in money or money's worth shall be divested of the lien and a like lien shall then attach to all the property of such transferee or trustee, except any part sold to a bona fide purchaser for a fair consideration in money or money's worth.

SEC. 410. That whoever knowingly makes any false statement in any notice or return required to be filed under this title shall be liable to a penalty of not exceeding $5,000, or imprisonment not exceeding one year, or both.

Whoever fails to comply with any duty imposed upon him by section 404, or, having in his possession or control any record, file, or paper, containing or supposed to contain any information concerning the estate of the decedent, or, having in his possession or control any property comprised in the gross estate of the decedent, fails to exhibit the same upon request to the Commissioner or any collector or law officer of the United States, or his duly authorized deputy or agent, who desires to examine the same in the performance of his duties under this title, shall be liable to a penalty of not exceeding $500, to be recovered, with costs of suit, in a civil action in the name of the United States.

SEC. 411. (a) That the term "resident" as used in this title includes a citizen of the United States with respect to whose property any probate or administration proceedings are had in the United States Court for China. Where no part of the gross estate of such decedent is situated in the United States at the time of his death, the total amount of tax due under this title shall be paid to or collected by the clerk of such court, but where any part of the gross estate of such decedent is situated in the United States at the time of his death, the tax due under this title shall be paid to or collected by the collector of the district in which is situated the part of the gross estate in the United States, or, if such part is situated in more than one district, then the collector of such district as may be designated by the Commissioner.

(b) For the purpose of this section the clerk of the United States Court for China shall be a collector for the territorial jurisdiction of such court, and taxes shall be collected by and paid to him in the same manner and subject to the same provisions of law, including penalties, as the taxes collected by and paid to a collector in the United States.

(c) The proviso in the Act entitled "An Act making appropriation for the Diplomatic and Consular Service for the fiscal year ending June 30, 1921," approved June 4, 1920, which reads as follows: *"Provided,* That in probate and administration proceedings there shall be collected by said clerk, before entering the order of final distribution, to be paid into the Treasury of the United States, the same inheritance taxes from time to time collected under the laws enacted by the Congress of the United States from the estates of decedents residing within the territorial jurisdiction of the United States," is hereby repealed.

TITLE X.—SPECIAL TAXES.

Capital Stock Tax

SEC. 1000. (a) That on and after July 1, 1922, in lieu of the tax imposed by section 1000 of the Revenue Act of 1918—

(1) Every domestic corporation shall pay annually a special excise tax with respect to carrying on or doing business, equivalent to $1 for each $1,000 of so much of the fair average value of its capital stock for the preceding year ending June 30 as is in excess of $5,000. In estimating the value of capital stock the surplus and undivided profits shall be included;

(2) Every foreign corporation shall pay annually a special excise tax with respect to carrying on or doing business in the United States, equivalent to $1 for each $1,000 of the average amount of capital employed in the transaction of its business in the United States during the preceding year ending June 30.

(b) The taxes imposed by this section shall not apply in any year to any corporation which was not engaged in business (or, in the case of a foreign corporation, not engaged in business in the United States) during the preceding year ending June 30, nor to any corporation enumerated in section 231, nor to any insurance company subject to the tax imposed by section 243 or 246.

(c) Section 257 shall apply to all returns filed with the Commissioner for purposes of the tax imposed by this section.

TITLE XIII.—GENERAL ADMINISTRATIVE PROVISIONS.

Laws Made Applicable

SEC. 1300. That all administrative, special, or stamp provisions of law, including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this Act, and every person liable to any tax imposed by this Act, or for the collection thereof, shall keep such records and render, under oath, such statements and returns,

and shall comply with such regulations as the Commissioner, with the approval of the Secretary, may from time to time prescribe.

Penalties

Sec. 1302. (a) That any person required under Titles V, VI, VII, VIII, IX, X, or XII, to pay, or to collect, account for and pay over any tax, or required by law or regulations made under authority thereof to make a return or supply any information for the purposes of the computation, assessment, or collection of any such tax, who fails to pay, collect, or truly account for and pay over any such tax, make any such return or supply any such information at the time or times required by law or regulation shall in addition to other penalties provided by law be subject to a penalty of not more than $1,000.

(b) Any person who willfully refuses to pay, collect, or truly account for and pay over any such tax, make such return or supply such information at the time or times required by law or regulation, or who willfully attempts in any manner to evade such tax, shall be guilty of a misdemeanor and in addition to other penalties provided by law shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

(c) Any person who willfully refuses to pay, collect, or truly account for and pay over any such tax shall in addition to other penalties provided by law be liable to a penalty of the amount of the tax evaded, or not paid, collected, or accounted for and paid over, to be assessed and collected in the same manner as taxes are assessed and collected: *Provided, however,* That no penalty shall be assessed under this subdivision for any offense for which a penalty may be assessed under authority of section 3176 of the Revised Statutes, as amended, or for any offense for which a penalty has been recovered under section 3256 of the Revised Statutes.

(d) The term "person" as used in this section includes an officer or employee of a corporation or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.

Rules and Regulations

Sec. 1303. That the Commissioner, with the approval of the Secretary, is hereby authorized to make all needful rules and regulations for the enforcement of the provisions of this Act.

The Commissioner, with such approval may by regulation provide that any return required by Titles V, VI, VII, VIII, IX, or X to be under oath may, if the amount of the tax covered thereby is not in excess of $10, be signed or acknowledged before two witnesses instead of under oath.

Fractional Parts of a Cent

Sec. 1306. That in the payment of any tax under this Act not payable by stamp a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent.

Returns

SEC. 1307. That whenever in the judgment of the Commissioner necessary he may require any person, by notice served upon him, to make a return or such statements as he deems sufficient to show whether or not such person is liable to tax.

Examination of Books and Witnesses

SEC. 1308. That the Commissioner, for the purpose of ascertaining the correctness of any return or for the purpose of making a return where none has been made, is hereby authorized, by any revenue agent or inspector designated by him for that purpose, to examine any books, papers, records, or memoranda bearing upon the matters required to be included in the return, and may require the attendance of the person rendering the return or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matter required by law to be included in such return, with power to administer oaths to such person or persons.

Unnecessary Examinations

SEC. 1309. That no taxpayer shall be subjected to unnecessary examinations or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Commissioner, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

Jurisdiction of Courts

SEC. 1310. (a) That if any person is summoned under this Act to appear, to testify, or to produce books, paper or other data, the district court of the United States for the district in which such person resides shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

(b) The district courts of the United States at the instance of the United States are hereby invested with such jurisdiction to make and issue, both in actions at law and suits in equity, writs and orders of injunction, and of ne exeat republica, orders appointing receivers, and such other orders and process, and to render such judgments and decrees, granting in proper cases both legal and equitable relief together, as may be necessary or appropriate for the enforcement of the provisions of this Act. The remedies hereby provided are in addition to and not exclusive of any and all other remedies of the United States in such courts or otherwise to enforce such provisions.

(c) Paragraph Twentieth of section 24 of the Judicial Code is amended by adding at the end thereof the following new paragraph:

"Concurrent with the Court of Claims, of any suit or proceeding, commenced after the passage of the Revenue Act of 1921, for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected

without authority or any sum alleged to have been excessive or in any manner wrongfully collected, under the internal-revenue laws, even if the claim exceeds $10,000, if the collector of internal-revenue by whom such tax, penalty, or sum was collected is dead at the time such suit or proceeding is commenced."

Amendments to Revised Statutes

SEC. 1311. That sections 3164, 3165, 3167, 3172, 3173 and 3176 of the Revised Statutes, as amended, are reenacted, without change, as follows:

"SEC. 3164. It shall be the duty of every collector of internal revenue having knowledge of any willful violation of any law of the United States relating to the revenue, within thirty days after coming into possession of such knowledge, to file with the district attorney of the district in which any fine, penalty, or forfeiture may be incurred, a statement of all the facts and circumstances of the case within his knowledge, together with the names of the witnesses, setting forth the provisions of law believed to be so violated on which reliance may be had for condemnation or conviction.

"SEC. 3165. Every collector, deputy collector, internal-revenue agent, and internal-revenue officer assigned to duty under an internal-revenue agent, is authorized to administer oaths and to take evidence touching any part of the administration of the internal-revenue laws with which he is charged, or where such oaths and evidence are authorized by law or regulation authorized by law to be taken.

"SEC. 3167. It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States to divulge or to make known in any manner whatever not provided by law to any person the operations, style of work, or apparatus of any manufacturer or producer visited by him in the discharge of his official duties, or the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; and it shall be unlawful for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses, or expenditures appearing in any income return; and any offense against the foregoing provision shall be a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court; and if the offender be an officer or employee of the United States he shall be dismissed from office or discharged from employment.

"SEC. 3172. Every collector shall, from time to time, cause his deputies to proceed through every part of his district and inquire after and concerning all persons therein who are liable to pay any internal-revenue tax, and all persons owning or having the care and management of any objects

liable to pay any tax, and to make a list of such persons and enumerate said objects.

"SEC. 3173. It shall be the duty of any person, partnership, firm, association, or corporation, made liable to any duty, special tax, or other tax imposed by law, when not otherwise provided for, (1) in case of a special tax, on or before the thirty-first day of July in each year, and (2) in other cases before the day on which the taxes accrue, to make a list or return, verified by oath, to the collector or a deputy collector of the district where located, of the articles or objects, including the quantity of goods, wares, and merchandise, made or sold and charged with a tax, the several rates and aggregate amount, according to the forms and regulations to be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, for which such person, partnership, firm, association, or corporation is liable: *Provided,* That if any person liable to pay any duty or tax, or owning, possessing, or having the care or management of property, goods, wares, and merchandise, articles or objects liable to pay any duty, tax, or license, shall fail to make and exhibit a list or return required by law, but shall consent to disclose the particulars of any and all the property, goods, wares, and merchandise, articles, and objects liable to pay any duty or tax, or any business or occupation liable to pay any tax as aforesaid, then, and in that case, it shall be the duty of the collector or deputy collector to make such list or return, which, being distinctly read, consented to, and signed and verified by oath by the person so owning, possessing, or having the care and management as aforesaid, may be received as the list of such person: *Provided further,* That in case no annual list or return has been rendered by such person to the collector or deputy collector as required by law, and the person shall be absent from his or her residence or place of business at the time the collector or a deputy collector shall call for the annual list or return, it shall be the duty of such collector or deputy collector to leave at such place of residence or business, with some one of suitable age and discretion, if such be present, otherwise to deposit in the nearest post office, a note or memorandum addressed to such person, requiring him or her to render to such collector or deputy collector the list or return required by law within ten days from the date of such note or memorandum, verified by oath. And if any person, on being notified or required as aforesaid, shall refuse or neglect to render such list or return within the time required as aforesaid, or whenever any person who is required to deliver a monthly or other return of objects subject to tax fails to do so at the time required, or delivers any return which, in the opinion of the collector, is erroneous, false, or fraudulent, or contains any undervaluation or understatement, or refuses to allow any regularly authorized Government officer to examine the books of such person, firm, or corporation, it shall be unlawful for the collector to summon such person, or any other person having possession, custody, or care of books of account containing entries relating to the business of such person or any other person he may

deem proper, to appear before him and produce such books at a time and place named in the summons, and to give testimony or answer interrogatories, under oath, respecting any objects or income liable to tax or the returns thereof. The collector may summon any person residing or found within the State or Territory in which his district lies; and when the person intended to be summoned does not reside and can not be found within such State or Territory, he may enter any collection district where such person may be found and there make the examination herein authorized. And to this end he may there exercise all the authority which he might lawfully exercise in the district for which he was commissioned: *Provided,* That 'person,' as used in this section, shall be construed to include any corporation, joint-stock company or association, or insurance company when such construction is necessary to carry out its provisions.

"Sec. 3176. If any person, corporation, company, or association fails to make and file a return or list at the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commisioner, or by a collector or deputy collector and approved by the Commissioner, shall be prima facie good and sufficient for all legal purposes.

"If the failure to file a return or list is due to sickness or absence, the collector may allow such further time, not exceeding thirty days, for making and filing the return or list as he deems proper.

"The Commissioner of Internal Revenue shall determine and assess all taxes, other than stamp taxes, as to which returns or lists are so made under the provisions of this section. In case of any failure to make and file a return or list within the time prescribed by law, or prescribed by the Commissioner of Internal Revenue or the collector in pursuance of law, the Commissioner of Internal Revenue shall add to the tax 25 per centum of its amount, except that when a return is filed after such time and it is shown that the failure to file it was due to a reasonable cause and not to willful neglect, no such addition shall be made to the tax. In case a false and fraudulent return or list is willfully made, the Commissioner of Internal Revenue shall add to the tax 50 per centum of its amount.

"The amount so added to any tax shall be collected at the same time and in the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, falsity, or fraud, in which case the amount so added shall be collected in the same manner as the tax."

Final Determinations and Assessments

Sec. 1312. That if after a determination and assessment in any case

the taxpayer has without protest paid in whole any tax or penalty, or accepted any abatement, credit, or refund based on such determination and assessment, and an agreement is made in writing between the taxpayer and the Commissioner, with the approval of the Secretary, that such determination and assessment shall be final and conclusive, then (except upon a showing of fraud or malfeasance or misrepresentation of fact materially affecting the determination or assessment thus made) (1) the case shall not be reopened or the determination and assessment modified by any officer, employee, or agent of the United States, and (2) no suit, action, or proceeding to annul, modify, or set aside such determination or assessment shall be entertained by any court of the United States.

Administrative Review

SEC. 1313. That in the absence of fraud or mistake in mathematical calculation, the findings of facts in and the decision of the Commissioner upon (or in case the Secretary is authorized to approve the same, then after such approval) the merits of any claim presented under or authorized by the internal-revenue laws shall not be subject to review by any other administrative officer, employee, or agent of the United States.

Retroactive Regulations

SEC. 1314. That in case a regulation or Treasury decision relating to the internal-revenue laws made by the Commissioner or the Secretary, or by the Commissioner with the approval of the Secretary, is reversed by a subsequent regulation or Treasury decision, and such reversal is not immediately occasioned or required by a decision of a court of competent jurisdiction, such subsequent regulation or Treasury decision may, in the discretion of the Commissioner, with the approval of the Secretary, be applied without retroactive effect.

Refunds

SEC. 1315. That section 3220 of the Revised Statutes, as amended, is reenacted without change, as follows:

"SEC. 3220. The Commissioner of Internal Revenue, subject to regulations prescribed by the Secretary of the Treasury, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected; also to repay to any collector or deputy collector the full amount of such sums of money as may be recovered against him in any court, for any internal revenue taxes collected by him, with the cost and expenses of suit; also all damages and costs recovered against any assessor, assistant assessor, collector, deputy collector, agent, or inspector, in any suit brought against him by reason of anything done in the due performance of his official duty, and shall make report to Congress at the beginning of each regular session of Congress of all transactions under this section."

SEC. 1316. That section 3228 of the Revised Statutes is amended to read as follows:

"SEC. 3228. All claims for the refunding or crediting of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty alleged to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, must be presented to the Commissioner of Internal Revenue within four years next after payment of such tax, penalty, or sum."

This section, except as modified by section 252, shall apply retroactively to claims for refund under the Revenue Act of 1916, the Revenue Act of 1917, and the Revenue Act of 1918.

SEC. 1317. That the paragraph of section 3689 of the Revised Statutes, as amended, reading as follows: "Refunding taxes illegally collected (internal revenue): To refund and pay back duties erroneously or illegally assessed or collected under the internal revenue laws," is repealed from and after June 30, 1920; and the Secretary of the Treasury shall submit for the fiscal year 1921 and annually thereafter, an estimate of appropriations to refund and pay back duties or taxes erroneously or illegally assessed or collected under the internal-revenue laws, and to pay judgments, including interest and costs, rendered for taxes or penalties erroneously or illegally assessed or collected under the internal-revenue laws.

Limitations upon Suits and Prosecutions

SEC. 1318. That section 3226 of the Revised Statutes is amended to read as follows:

"SEC. 3226. No suit or proceeding shall be maintained in any court for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Commissioner of Internal Revenue, according to the provisions of law in that regard, and the regulations of the Secretary of the Treasury established in pursuance thereof. No such suit or proceeding shall be begun before the expiration of six months from the date of filing such claim unless the Commissioner renders a decision thereon within that time, nor after the expiration of five years from the date of the payment of such tax penalty, or sum."

This section shall not affect any suit or proceeding instituted prior to the passage of this Act, but shall apply to all suits and proceedings instituted after the passage of this Act, whether or not barred by prior Acts of Congress.

SEC. 1319. That section 3227 of the Revised Statutes is hereby repealed but such repeal shall not affect any suit or proceeding instituted prior to the passage of this Act.

SEC. 1320. That no suit or proceeding for the collection of any internal revenue tax shall be begun after the expiration of five years from

the time such tax was due, except in the case of fraud with intent to evade tax, or willful attention in any manner to defeat or evade tax. This section shall not apply to suits or proceedings for the collection of taxes under section 250 of this Act, nor to suits or proceedings begun at the time of the passage of this Act.

SEC. 1321. (a) That the Act entitled "An Act to limit the time within which prosecutions may be instituted against persons charged with violating internal-revenue laws," approved July 5, 1884, is amended to read as follows:

"That no person shall be prosecuted, tried, or punished for any of the various offenses arising under the internal-revenue laws of the United States unless the indictment is found or the information instituted within three years next after the commission of the offense: *Provided,* That the time during which the person committing the offense is absent from the district wherein the same is committed shall not be taken as any part of the time limited by law for the commencement of such proceedings: *Provided further,* That the provisions of this Act shall not apply to offenses committed prior to its passage: *Provided further,* That where a complaint shall be instituted before a commissioner of the United States within the period above limited, the time shall be extended until the discharge of the grand jury at its next session within the district: *And provided further,* That this Act shall not apply to offenses committed by officers of the United States."

(b) Any prosecution or proceeding under an indictment found or information instituted prior to the passage of this Act shall not be affected in any manner by this amendment, but such prosecution or proceeding shall be subject to the limitations imposed by law prior to the passage of this Act.

Assessments

SEC. 1322. That all internal revenue taxes, except as provided in section 250 of this Act, shall, notwithstanding the provisions of section 3182 of the Revised Statutes or any other provision of law, be assessed within four years after such taxes became due, but in the case of fraud with intent to evade tax or willful attempt in any manner to defeat or evade tax, such tax may be assessed at any time.

Fraudulent Returns

SEC. 1323. That section 3225 of the Revised Statutes of the United States, as amended, is reenacted without change as follows:

"SEC. 3225. When a second assessment is made in case of any list, statement, or return, which in the opinion of the collector or deputy collector was false or fraudulent, or contained any understatement or undervaluation, such assessment shall not be remitted, nor shall taxes collected under such assessment be refunded or paid back, or recovered by any suit, unless it is proved that such list, statement, or return was not

willfully false or fraudulent and did not contain any willful understatement or undervaluation."

Interest on Refunds and Judgments

SEC. 1324. (a) That upon the allowance of a claim for the refund of or credit for internal revenue taxes paid, interest shall be allowed and paid upon the total amount of such refund or credit at the rate of one-half of 1 per centum per month to the date of such allowance, as follows: (1) if such amount was paid under a specific protest setting forth in detail the basis of and reasons for such protest, from the time when such tax was paid, or (2) if such amount was not paid under protest but pursuant to an additional assessment, from the time such additional assessment was paid, or (3) if no protest was made and the tax was not paid pursuant to an additional assessment, from six months after the date of filing of such claim for refund or credit. The term "additional assessment" as used in this section means a further assessment for a tax of the same character previously paid in part.

(b) Section 177 of the Judicial Code is amended to read as follows:

"SEC. 177. No interest shall be allowed on any claim up to the time of the rendition of judgment by the Court of Claims, unless upon a contract expressly stipulating for the payment of interest, except that interest may be allowed in any judgment of any court rendered after the passage of the Revenue Act of 1921 against the United States for any internal-revenue tax erroneously or illegally assessed or collected, or for any penalty collected without authority or any sum which was excessive or in any manner wrongfully collected, under the internal-revenue laws."

Payment of Taxes by Check or United States Securities

SEC. 1325. That collectors may receive, at par with an adjustment for accrued interest, notes or certificates of indebtedness issued by the United States and uncertified checks in payment of income, war-profits and excess-profits taxes and any other taxes payable other than by stamp, during such time and under such regulations as the Commissioner, with the approval of the Secretary, shall prescribe; but if a check so received is not paid by the bank on which it is drawn the person by whom such check has been tendered shall remain liable for the payment of the tax and for all legal penalties and additions the same as if such check had not been tendered.

Frauds on Purchasers

SEC. 1326. That whoever in connection with the sale of lease, or offer for sale or lease, of any article, or for the purpose of making such sale or lease, makes any statement, written or oral, (1) intended or calculated to lead any person to believe that any part of the price at which such article is sold or leased, or offered for sale or lease, consists of a tax imposed under the authority of the United States, or (2) ascribing a

particular part of such price to a tax imposed under the authority of the United States, knowing that such statement is false or that the tax is not so great as the portion of such price ascribed to such tax, shall be guilty of a misdemeanor and upon conviction thereof shall be punished by a fine of not more than $1,000 or by imprisonment not exceeding one year, or both.

Tax Simplification Board

SEC. 1327. (a) That there is hereby established in the Department of the Treasury a board to be known as the "Tax Simplification Board" (hereinafter in this section called the "Board"), to be composed as follows:

(1) Three members who shall represent the public, to be appointed by the President; and

(2) Three members who shall represent the Bureau of Internal Revenue and shall be officers or employees of the United States serving in such Bureau, to be appointed by the Secretary.

(b) Any vacancy in the Board shall be filled in the same manner as the original appointment. The members representing the public shall serve without compensation except reimbursement for traveling, subsistence, and other necessary expenses incurred in the performance of the duties vested in them by this section. The members representing the Bureau of Internal Revenue shall serve without compensation in addition to that received for their service in such Bureau.

(c) The Secretary shall furnish the Board with such clerical assistance, quarters and stationery, furniture, office equipment, and other supplies as may be necessary for the performance of the duties vested in them by this section.

(d) It shall be the duty of the Board to investigate the procedure of and the forms used by the Bureau in the administration of the internal revenue laws, and to make recommendations in respect to the simplification thereof. The Board shall make a report to the Congress on or before the first Monday of December in each year.

(e) The expenditures of the Board shall be paid upon vouchers approved by the Board and signed by the chairman thereof. For the expenditures of the Board for the fiscal year ending June 30, 1922, there is authorized to be appropriated, out of any money in the Treasury not otherwise appropriated, the sum of $10,000.

(f) The Board shall cease to exist on December 31, 1924.

Consolidation of Liberty Bond Tax Exemptions

SEC. 1328. That the various Acts authorizing the issues of Liberty bonds are amended and supplemented as follows:

(a) On and after January 1, 1921, 4 per centum and 4¼ per centum Liberty bonds shall be exempt from graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, now or hereafter imposed by the United States upon the income or

profits of individuals, partnerships, corporations, or associations in respect to the interest on aggregate principal amounts thereof as follows:

Until the expiration of two years after the date of the termination of the war between the United States and the German Government, as fixed by proclamation of the President, on $125,000 aggregate principal amount; and for three years more on $50,000 aggregate principal amount.

(b) The exemptions provided in subdivision (a) shall be in addition to the exemptions provided in section 7 of the Second Liberty Bond Act, and in addition to the exemption provided in subdivision (3) of section 1 of the Supplement to the Second Liberty Bond Act in respect to bonds issued upon conversion of 3½ per centum bonds, but shall be in lieu of the exemptions provided and free from the conditions and limitations imposed in subdivisions (1) and (2) of section 1 of the Supplement to Second Liberty Bond Act and in section 2 of the Victory Liberty Loan Act.

Deposit of United States Bonds or Notes in Lieu of Surety

SEC. 1329. That wherever by the laws of the United States or regulations made pursuant thereto, any person is required to furnish any recognizance, stipulation, bond, guaranty, or undertaking, hereinafter called "penal bond," with surety or sureties, such person may, in lieu of such surety or sureties, deposit as security with the official having authority to approve such penal bond, United States Liberty bonds or other bonds or notes of the United States in a sum equal at their par value to the amount of such penal bond required to be furnished, together with an agreement authorizing such official to collect or sell such bonds or notes so deposited in case of any default in the performance of any of the conditions or stipulations of such penal bond. The acceptance of such United States bonds or notes in lieu of surety or sureties required by law shall have the same force and effect as individual or corporate sureties, or certified checks, bank drafts, post-office money orders, or cash, for the penalty or amount of such penal bond. The bonds or notes deposited hereunder and such other United States bonds or notes as may be substituted therefor from time to time as such security, may be deposited with the Treasurer of the United States, a Federal reserve bank, or other depositary duly designated for that purpose by the Secretary, which shall issue receipt therefor, describing such bonds or notes so deposited. As soon as security for the performance of such penal bond is no longer necessary, such bonds or notes so deposited, shall be returned to the depositor: *Provided,* That in case a person or persons supplying a contractor with labor or material as provided by the Act of Congress, approved February 24, 1905 (33 Stat. 811), entitled "An Act to amend an Act approved August thirteenth, eighteen hundred and ninety-four, entitled 'An Act for the protection of persons furnishing materials and labor for the construction of public works,'" shall file with the obligee, at any time after a default in the performance of any contract subject to

said Acts, the application and affidavit therein provided, the obligee shall not deliver to the obligor the deposited bonds or notes nor any surplus proceeds thereof until the expiration of the time limited by said Acts for the institution of suit by such person or persons, and, in case suit shall be instituted within such time, shall hold said bonds or notes or proceeds subject to the order of the court having jurisdiction thereof: *Provided further,* That nothing herein contained shall affect or impair the priority of the claim of the United States against the bonds or notes deposited or any right or remedy granted by said Acts or by this section to the United States for default upon any obligation of said penal bonds: *Provided further,* That all laws inconsistent with this section are hereby so modified as to conform to the provisions hereof: *And provided further,* That nothing contained herein shall affect the authority of courts over the security, where such bonds are taken as security in judicial proceedings, or the authority of any administrative officer of the United States to receive United States bonds for security in cases authorized by existing laws. The Secretary may prescribe rules and regulations necessary and proper for carrying this section into effect.

Lost Stamps for Tobacco, Cigars, and So Forth

SEC. 1330. That section 3315 of the Revised Statutes, as amended, is reenacted without change, as follows:

"SEC. 3315. The Commissioner of Internal Revenue may, under regulations prescribed by him with the approval of the Secretary of the Treasury, issue stamps for restamping packages of distilled spirits, tobacco, cigars, snuff, cigarettes, fermented liquors, and wines which have been duly stamped but from which the stamps have been lost or destroyed by unavoidable accident."

Consolidated Returns for Year 1917

SEC. 1331. (a) That Title II of the Revenue Act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporations and domestic partnerships that were affiliated during the calendar year 1917.

(b) For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others, or (2) when substantially all the stock of two or more corporations or the business of two or more partnerships was owned by the same interests: *Provided,* That such corporations or partnerships were engaged in the same or a closely related business, or one corporation or partnership bought from or sold to another corporation or partnership products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or one corporation or

partnership in any way so arranged its financial relationships with another corporation or partnership as to assign to it a disproportionate share of net income or invested capital. For the purposes of this section, public service corporations which (1) were operated independently, (2) were not physically connected or merged and (3) did not receive special permission to make a consolidated return, shall not be construed to have been affiliated; but a railroad or other public utility which was owned by an industrial corporation and was operated as a plant facility or as an integral part of a group organization of affiliated corporations which were required to file a consolidated return, shall be construed to have been affiliated.

(c) The provisions of this section are declaratory of the provisions of Title II of the Revenue Act of 1917.

Alternative Tax on Personal Service Corporations

Sec. 1332. (a) That if either subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act is by final adjudication declared invalid, there shall, in addition to all other taxes, be levied, collected, and paid on the net income (as defined in section 232) received during the calendar years 1918, 1919, 1920, and 1921, by every personal service corporation (as defined in section 200) included within the provisions of such subdivisions, a tax equal to the taxes imposed by Titles II and III of the Revenue Act of 1918 and, in the case of income received during the calendar year 1921, by Titles II and III of this Act.

(b) In such event every such personal service corporation shall, on or before the fifteenth day of the sixth month following the date of entry of decree upon such final adjudication, make a return of any income received during each of the calendar years 1918, 1919, 1920, and 1921 in the manner prescribed by the Revenue Act of 1918 (or in the manner prescribed by this Act, in the case of income received during the calendar year 1921). Such return shall be made and the net income shall be computed on the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in the manner provided for other corporations under the Revenue Act of 1918 and this Act.

(c) If either subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act is so declared invalid, claims for credit or refund of taxes paid under both such sections shall be allowed, if made within the time provided in subdivision (f) of this section.

(d) In case the claims for credit or refund, filed within six months from such date of entry of decree, represent less than 30 per centum of the outstanding stock or shares in the corporation, the amount of taxes imposed by this section upon such corporation shall be reduced to that proportion thereof which the number of stock or shares owned by the shareholders or members making such claims bears to the total number of stock or shares outstanding.

(e) The tax imposed by this section shall be assessed, collected, and paid upon the same basis, in the same manner, and subject to the same provisions of law, including penalties, as the taxes imposed by sections 230 and 301 of the Revenue Act of 1918 (or by sections 230 and 301 of this Act, in the case of income received during the calendar year 1921), but no interest or penalties shall be due or payable thereon for any period prior to the date upon which the return is by this section required to be made and the first installment paid. The amount of tax paid by any shareholder or member of a personal service corporation pursuant to the provisions of subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act shall be credited against the tax due from such corporation under this section upon the joint written application of such corporation and such shareholder or member of his representatives, heirs, or assigns, if such application is filed with the Commissioner within six months from such date of entry of decree.

(f) Notwithstanding any other provision of law, no claim for a credit or refund of taxes paid under subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act, may be filed after the expiration of six months from such date of entry of decree: *Provided, however,* That a personal service corporation of which no shareholder or member has filed such claim within such period of six months shall not be subject to the tax imposed by this section.

TITLE XIV.—GENERAL PROVISIONS

Repeals

SEC. 1400. (a) That the following parts of the Revenue Act of 1918 are repealed, to take effect (except as otherwise provided in this Act) on January 1, 1922, subject to the limitations provided in subdivision (b):

Title II (called "Income Tax") as of January 1, 1921;

Title III (called "War-Profits and Excess-Profits Tax") as of January 1, 1921;

Title IV (called "Estate Tax") on the passage of this Act;

Title X (called "Special Taxes");

Sections 1314, 1315, 1316, 1317, 1319, and 1320 of Title XIII (being certain administrative provisions) on the passage of this Act.

(b) The parts of the Revenue Act of 1918 which are repealed by this Act shall (unless otherwise specifically provided in this Act) remain in force for the assessment and collection of all taxes which have accrued under the Revenue Act of 1918 at the time such parts cease to be in effect, and for the imposition and collection of all penalties or forfeitures which have accrued or may accrue in relation to any such taxes. In the case of any tax imposed by any part of the Revenue Act of 1918 repealed by this Act, if there is a tax imposed by this Act in lieu thereof, the provision imposing such tax shall remain in force until the corresponding tax under

this Act takes effect under the provisions of this Act. The unexpended balance of any appropriation heretofore made and now available for the administration of any such part of the Revenue Act of 1918 shall be available for the administration of this Act or the corresponding provision thereof.

Increase in Treasury Savings Certificate Limit

SEC. 1402. That section 6 of the Second Liberty Bond Act, as amended, is amended by striking out in the next to the last sentence thereof the figures "$1,000" and inserting in lieu thereof the figures "$5,000."

Saving Clause in Event of Unconstitutionality

SEC. 1403. That if any provision of this Act, or the application thereof to any person or circumstances, is held invalid, the remainder of the Act, and the application of such provision to other persons or circumstances, shall not be affected thereby.

Effective Date of Act.

SEC. 1404. That except as otherwise provided, this Act shall take effect upon its passage.

Approved, November 23, 1921, at 3.55 p. m.

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